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THE IMPACT OF THE TAX SYSTEM ON BASIC INDUSTRY, SERVICE INDUSTRIES, AND THE INVESTMENT INDUSTRIES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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THE IMPACT OF THE TAX SYSTEM ON BASIC INDUSTRY, SERVICE INDUSTRIES, AND THE INVESTMENT INDUSTRIES

MONDAY, JUNE 18, 1984

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:37 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman) presiding.

Present: Senator Grassley.

[The press release announcing the hearing and the opening statement of Senator Grassley follow:]

[Press Release No. 84-143]

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS HEARING ON IMPACT OF THE TAX SYSTEM ON BASIC INDUSTRY, SERVICE INDUSTRIES, AND THE INVESTMENT INDUSTRIES

Senator Charles E. Grassley (R., Iowa), Chairman of the Finance Subcommittee on Oversight of the Internal Revenue Service, announced today that the Subcommittee will hold a hearing to examine the impact of the Federal income tax system on basic industry, service industries, and the investment industries.

The hearing will be held on Monday, June 18, 1984 at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"Past hearings in this series have covered the agriculture and small business segments of the economy, as well as a general overview of the economic scene. The purpose has been to understand the impact of the Federal tax system on individual decisions in the economy: to examine microeconomic effects as the basis for improving the Federal tax system," Senator Grassley stated.

Senator Grassley noted that "witnesses should be prepared to address such productivity issues as how our tax system and its administration by the Internal Revenue Service affects basic industry, service industries, and the investment industries.

OPENING REMARKS OF SENATOR CHARLES E. GRASSLEY, CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

I want to welcome the witnesses, who have taken time out of their schedules and have agreed to come here today to testify on important areas relating to the impact of the Internal Revenue Code on productivity.

The hearing today is another in a series that the Subcommittee on Oversight of the Internal Revenue Service is holding to develop information, suggestions, and recommendations for the Committee on Finance in its work on efforts to make the tax system workable. I think that the ultimate goal of all of us concerned about the tax system is to work toward systemic tax reform. These hearings are also valuable in that regard, for they help us to understand the large problem areas that now exist under the current federal tax system.

Past hearings in this series have covered the agriculture and small business segments of the economy, as well as providing a general overview of the economic scene. These hearings have helped to develop an understanding of the impact of the federal tax system on individual decisions in the economy. The hearings examine the micro-economic effects of the tax system in order to develop a basis for improving that system.

Today we will hear expert witnesses testify about the impact of the tax system on productivity in three areas: basic industries, service industries, and the investment industries.

We will begin with the basic industries, by which we mean heavy industries, those that produce coal, iron, steel, paper and many others. We also include the heavy manufacturers, such as the automobile and shipbuilding industries. These industries form the bedrock of an industrial society, and are vital to national defense as well as to domestic well-being.

Then we will turn to the service industries, which provide the vast and unmatched system of communications and transport that we have in America. Airlines, trucking firms, railroads, facilities construction, and water transport companies provide the means of moving people and goods around the Nation. Other service industries range from the telephone companies and air express companies to the neighborhood drycleaning establishments.

Finally, we will examine the investment industries. Let me differentiate immediately between the primary and secondary investment markets. The primary market consists of the initial sources of capital: household savings, business reinvestment of retained earnings, purchases of stocks or bonds, etc. Secondary investment consists of money invested in money markets. We are interested in both kinds, of course, so that we can better understand how the tax system affects investor decisions and the operation of the investment industries.

There are many individual economic activities and factors that affect true productivity. For example, there are such important areas as inventory levels, new equipment or modernization, equity vs. debt financing, mergers and acquisitions, and tax shelters.

Our business managers must balance their decisions between tax forces and economic forces. Our present tax system by its effect on the myriad micro-influences on our profit-making national will, sometimes generates profits in ways that produce neither goods or services that improve our quality of life. This effect is not productive.

It would seem that our national heritage could be better fulfilled if we could find ways to make our tax system more neutral and less forceful in our economic life. I would like the witnesses to address these issues in the strongest terms possible.

Senator **Grassley**. Ladies and gentlemen, I would like to call this hearing to order, and I would like to say thank you to everybody who is here—those who are testifying as well as those who are here just to listen. And I hope that those who are here to testify don't find their time divided between the very serious aspects of this hearing as well as the very serious aspects of what is going on in the conference committee between the House and Senate.

I know for those of you who are in business here in town full-time in tax legislation, that perhaps that may be the case.

I want to tell you that, under those circumstances, for those of you who have dual loyalties between this hearing as well as the work of the conference committee, I want to thank you for accommodating my effort to get out additional information on how the Tax Code affects productivity.

Now, this is another in a series of hearings by this subcommittee, which is the Subcommittee on Oversight of the Internal Revenue Service, holding hearings to develop information, suggestions and recommendations for the Committee on Finance in our work and our efforts to make the tax system workable and contribute to the productivity of our economy.

I think that the ultimate goal of all of us concerned with the tax system is to work toward a systemic tax reform. These hearings are also valuable in that regard, for they help us to understand the large problem areas that now exist under the current Federal tax system.

Past hearings—and I think this is the third in this series—have covered the agriculture and small business segments of the economy as well as providing a general overview of the economic scene. These hearings have helped to develop an understanding of the impact of the Federal tax system on individual decisionmaking in the economy and how that individual decisionmaking as modified by the Tax Codes contributes or inhibits productivity.

The hearings examine the microeconomic effects of the tax system in order to develop a basis for improving that system.

Today we will hear witnesses testify about the impact of the tax system on productivity in three areas: basic industry, service industries, and the investment industries. We will begin with the basic industries, by which we mean heavy industries. In addition to the many aspects that those industries produce—coal, iron, steel, paper—we also will include the heavy manufacturers such as the automobile and shipbuilding industries. These industries we know are the bedrock of the industrial society and are vital as well to the national defense as they are to the domestic well-being.

Then we will move to a view of the service industries, which provide the vast and unmatched system of communications and transport that we have in this great country of ours—airlines, trucking firms, railroads, facility construction, and water transport companies provide the means of moving and goods around our Nation and contribute very much to an efficient economy.

Other service industries range from the telephone companies and air express companies to the neighborhood dry cleaning establishments.

Finally, we will examine the investment industries. And for this purpose I would like to differentiate between the primary and secondary markets. The primary markets consist of the initial sources of capital; the secondary investments consist of money invested in money markets. We are interested in both kinds, of course, so that we can better understand how the tax system affects investor decisions and the operation of investment industries.

There are many individual economic activities and factors that affect true productivity. For example, there are such important areas as inventory levels, new equipment and modernization, equity versus debt financing, mergers and acquisitions, and tax shelters.

Our business managers, of course, must balance their decisions between tax forces and economic forces, and they are intertwined to a great extent.

Our present tax system, by its effect on the myriad micro-influences on our profitmaking national will sometimes generates profits in ways that produce neither goods nor services that improve the quality of life. This effect is not productive.

It would seem that our national heritage could be better fulfilled if we could find ways to make our tax system more neutral and less forceful in the decisions that affect economic life.

I would like the witnesses to address these issues in the strongest terms possible.

I would like to now call the representatives of the Office of Technology Assessment. Our first witness is Dr. John A. Alic, Project Director, connected with this very important arm of the Congress of the United States.

Would you come, please?

While you are sitting I would also like to make some housekeeping announcements; let me check with staff here.

[Pause.]

Senator **Grassley**. I just wanted to check with staff as to whether we are going to have 5 minutes or 10 minutes of testimony, and I think they made a wise decision of recommending 5 minutes, because we do have three very big panels.

Of course, in pursuit of that, as so many of you are familiar, the entire statement will be included in the record. We would like to have you summarize. For some of you I have some questions, too. But also, my questions—of necessity, because I haven't been able to go over all of the testimony ahead of time and neither has my staff been able to—we would hope as far as the panel is concerned, because we have such a vast array of people testifying today, that maybe there can be some questions raised and answered among the experts on the individual panels. Hopefully my general questions will bring about some of that, because we want to leave no stone unturned as to how it gets down to individual specific decisionmaking the Tax Code either encourages or discourages productivity.

So, with those comments in mind, I guess I will make one additional statement, and that is simply that the record will stay open for 15 days for people who want to make corrections or additions. They can so do.

Would you proceed, Doctor?

STATEMENT OF DR. JOHN A. ALIC, PROJECT DIRECTOR, OFFICE OF TECHNOLOGY ASSESSMENT, U.S. CONGRESS, WASHINGTON, DC

Dr. **Alic**. Thank you, Mr. Chairman.

I will summarize my written statement briefly.

I am pleased to be here this morning to comment on a very important subject, one that the Office of Technology Assessment has addressed in a number of reports dealing with the international competitiveness of American industries. We have looked at the electronics industry, steel, automobiles, and several other sectors of our economy.

Because this work has been at the sectoral level, whether the steel industry or microelectronics, our analyses reveal relationships among competitiveness, productivity and the tax system in a somewhat different light than more conventional economic studies might.

These relationships are not simple ones. For example, an industry may need to improve its productivity, however we choose to define "productivity," in order to strengthen its international competitive position; yet, that might not be enough. Changes elsewhere in the world economy may have overriding impacts. Indeed, productivity can increase rapidly even in sectors with slipping competitiveness, posing a series of cruel dilemmas for industries and for their employees.

Even in sectors which are competitively strong, productivity may improve and output may expand while job opportunities decline. Why? Simply because output may not grow as rapidly as productivity.

My written statement includes some examples which illustrate these impacts, particularly in the case of the American automobile industry and its current competition with automakers in Japan.

International competitiveness depends not only on productivity, but also on many other factors. Competitiveness is an illusive concept; at the sectoral level, it cannot be measured by market shares, output levels, profits, employment, technological capability in isolation.

At the same time, the Nation is by definition competitive in the goods and services it exports. This means that the United States cannot be "uncompetitive" so long as it trades.

The goods and services that the United States can sell overseas—timber, commercial aircraft, computer software, banking services—will depend in part on productivity levels in these various sectors of our economy. Even if American steel companies, for example, make dramatic strides in productivity, they might not be able to compete very effectively for export sales with other American goods—for example, computers or aircraft. The reason is straightforward: Many companies can make steel at costs not too far different from costs in the United States; few countries can make mainframe computers or commercial aircraft efficiently.

How, then, does the Federal Government influence the productivity and competitiveness of U.S. industries? In general, the Government and the Tax Code enter the picture through effects on individual firms. It is necessary to look at sector-specific and firm-specific impacts to set the Tax Code against other forms of Federal influence on productivity and competitiveness.

The Tax Code affects these primarily through corporate taxes. Although personal income taxes and other forms of taxation, including international differences such as the use of value-added taxes in foreign countries, may affect market shares and other currents in international trade, within the domestic economy, it is corporate taxes that are most important.

Of course, corporate taxes have declined in the United States as a result of the Economic Recovery Tax Act of 1981; but, as the table on page 10 of my written statement shows, differences in tax treatment of the various sectors of the American economy have increased. The spread in rates across sectors is higher.

One result—largely unintended but no less real—has been to shift the relative attractiveness of new investments in various economic sectors. Everything else the same, for example, investments in petroleum refineries have become more attractive compared to investments in chemicals. Again, my written statement includes more examples of the impact of the increase in the spread of effective tax rates across sectors.

In the end, to judge the relative impact of taxes we must set the tax system against other influences on business decisions. Is tax policy more or less important than, for example, the financing that governments provide for overseas sales through export-import banks? The Federal deficit with its effect on interest rates and the value of the dollar? Federal R&D expenditures?

To answer such questions takes industry-specific analysis, if not firm-specific analysis, the kind of analysis, Mr. Chairman, that we have been conducting for 5 years and more at the Office of Technology Assessment in our studies of competitiveness.

In conclusion, taxes enter the picture in many, many ways. Mortgage interest deductions can affect people's willingness to sell their home to move to a new job—not unimportant in an economy like ours where high labor mobility has helped entrepreneurial sectors such as the semiconductor industry to thrive and grow.

Income tax deductions for education and training expenses can make such programs more or less attractive with subsequent impacts on productivity.

The lessen is this: Most of the impacts of the tax system on productivity are indirect; they are side effects of policies often adopted for purposes other than the stimulus of productivity or competitiveness. Most of these impacts are sector-specific and firm-specific. Individually, they may be small. Cumulatively, they may be large in one industry but small in another.

In the United States, the Federal Government has seldom looked at tax policy or any other policy as a tool for stimulating productivity. We have little experience in doing this, but a great deal of experience in the political compromises that go into the making of tax policy.

If I may end with a question, would it be realistic, given this history and given our political system, for the United States to attempt in self-conscious fashion to use the Tax Code for stimulating productivity and competitiveness?

Thank you.

[The prepared statement of Dr. Alic follows:]

STATEMENT OF

JOHN A. ALIC

PROJECT DIRECTOR, OFFICE OF TECHNOLOGY ASSESSMENT

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

COMMITTEE ON FINANCE

U.S. SENATE

June 18, 1984

Mr. Chairman and Senators, I am pleased to be here this morning to comment for the Office of Technology Assessment on a very important subject: productivity, and in particular the effects of the U.S. tax code on productivity. OTA has assessed the international competitiveness of several U.S. manufacturing industries. My statement draws from these reports, the most recent of which, International Competitiveness in Electronics, was published last November. OTA's work on competitiveness goes back much farther than this, to Technology and Steel Industry Competitiveness, published in 1980, and includes a report on U.S. Industrial Competitiveness: A Comparison of Steel, Electronics, and Automobiles. These three studies, together with a number of other assessments dealing less directly with international competitiveness, give OTA a substantial base of experience in industry-specific analysis. My statement draws on this body of experience.

Because OTA's work has begun at the sectoral level -- whether the steel industry or microelectronics -- our analyses reveal relationships among competitiveness, productivity, and the tax system in somewhat different light than more conventional economic studies might. These relationships are not simple ones. For example, an industry may need to improve its productivity, however defined (labor productivity, total factor productivity), in order to strengthen its international competitive position. Yet that might not be enough. Changes elsewhere in the world economy may have overriding impacts. Indeed, productivity can increase rapidly even in sectors with slipping competitiveness, posing a series of cruel dilemmas for industries and their employees. And in sectors which are competitively strong, productivity may improve and output expand while job opportunities decline. Why? Simply because output may not grow as rapidly as productivity.

SMALL CAR PRODUCTION: A BRIEF EXAMPLE

American automobile manufacturers have been able to increase their productivity very substantially over the past several years. But, while returning to profitability -- aided by surging demand for larger cars -- they have not been able to erase the cost advantages of the Japanese in small cars. For the forseeable future, the billions of dollars U.S. automakers have invested in new production facilities and in design and development will not suffice to overcome the advantages of Japanese producers in the small-car segment of the market.

This is not just a matter of productivity. The sources of Japanese advantage are multiple: vehicle designs which may be somewhat cheaper to manufacture; lower labor costs; in some cases, greater production scale; efficient approachs to quality control, tooling, factory layout, inventory control, and the systems aspects of manufacturing.

For exports to the United States, advantages that may accrue from the yen-dollar exchange rate and rebates of commodity (value-added) taxes on exports can be added to the list. In general, indirect taxes -- those, such as Japan's commodity taxes, levied on the product itself rather than on profits or payrolls -- give advantages in international trade where the exporting nation grants exemptions or rebates. The General Agreement on Tariffs and Trade explicitly permits such practices, one of the reasons many nations rely quite heavily on value-added taxes. While affecting pricing and profits in export markets, however, this aspect of the tax system will have less impact on productivity.

Indeed, it is not at all clear how productivity levels in the Japanese automobile industry compare to those in the United States.

Productivity will be different for different car lines, and for the same model produced in different factories. Japanese steel is cheaper; so are Japanese tires. Productivity will vary among manufacturers and among their suppliers. One manufacturer may have a low level of vertical integration, as does Chrysler and several of the Japanese automakers, which buy many components from outside suppliers. If the suppliers achieve high productivity levels, this may help the automaker control its costs. On the other hand, suppliers may have lower productivity but also pay lower wages. Such factors make it difficult to estimate manufacturing cost differentials between the two industries. One of the few things that is clear is that Japan's automakers, on the average, have a substantial manufacturing cost advantage for small cars, and that productivity differences account for only a portion of this advantage -- although that portion no doubt exceeds half.

PRODUCTIVITY AND COMPETITIVENESS

As the example above illustrates, international competitiveness depends on productivity but also on other factors. The relationships between productivity and competitiveness are doubly confusing because both terms can be defined in several ways.

As conventionally measured, productivity affects competitiveness only at the manufacturing stage. Here productivity may mean labor productivity -- value-added per worker-hour or physical output (for example, tons of steel) per hour, or it may be defined in terms of other factors of production (capital, energy). While there is no reason in principle why productivity in design and development could not be measured, or productivity in management, in practice almost all the data available has been collected for manufacturing operations.

Competitiveness is more elusive. In OTA's view, competitiveness cannot be measured by market shares alone, nor by output levels, profits, employment, or technological capability. Nor can it be measured by productivity. All these are potential indicators of competitiveness, but cannot stand by themselves -- whether our concern is to compare the United States with other nations in electronics, or to compare one U.S. industry to another.

In essence, there are no direct indicators of international competitiveness -- the ability of firms in a given country to design, development, manufacture, and market their products in competition with firms based elsewhere. Furthermore, while productivity can be a vital piece of data for evaluating competitiveness and analyzing the sources of shifts, in sectors like microelectronics or computers -- where technological change is rapid -- productivity cannot really be measured. The output of these industries today is simply not comparable with that of yesterday. As a result, productivity trends over time for making, say, integrated circuits, cannot be related in any meaningful way to productivity trends elsewhere in the economy. (Comparisons between domestic sectors, where possible, are fundamental tools for analyzing competitiveness.)

At the same time, any nation is by definition competitive in the goods and services it exports. This means that the United States cannot be "uncompetitive" so long as it trades -- a statement not so trivial as it might seem. The goods and services that the United States can sell overseas -- timber, commercial aircraft, computer software, banking services -- will depend in part on productivity levels in various sectors of our economy.

In determining competitiveness, productivity in one domestic sector compared to others in the domestic economy carries more weight than productivity in the U.S. sector compared to productivities in the same sector overseas. When it comes to price competition between American and Japanese automakers for U.S. sales, the productivity levels in the two industries are important. When it comes to understanding why the United States finds itself importing small cars or steel while exporting computers, or exporting textiles and synthetic fibers while importing apparel, the relative trends over time of productivity in each of these domestic industries are more important. The simple fact is that the United States must import if it is to export. We find ourselves exporting goods and services that, to purchasers overseas, offer the best values. Even if American steel companies were to make dramatic strides in productivity, they would not be able to compete very effectively for export sales with other American goods -- e.g., computers or aircraft. The reason is straightforward. Many countries can make steel at costs not far different from U.S. costs. Few countries can make mainframe computers or commercial aircraft efficiently.

In turn, the goods and services that the United States can sell abroad will help determine wage levels and overall living standards for Americans. The chain is this: in each sector of our economy, productivity affects competitiveness; the competitiveness of these sectors will, collectively, determine what the United States imports and what it exports; the composition of U.S. trade is then a major factor in determining our standard of living. In other words, the economy's productivity at the aggregate level -- measured in terms such as GDP (gross domestic product) per capita -- becomes one of the outcomes of international rivalries.

HOW DOES THE FEDERAL GOVERNMENT INFLUENCE THE PRODUCTIVITY AND COMPETITIVENESS OF U.S. INDUSTRIES?

Government, and the tax code, enters the picture primarily through effects on individual firms, and, at a higher level of aggregation, through the competitive dynamics of each sector. Ultimately, the competitiveness of any U.S. manufacturing industry will depend on the efforts of individual firms to develop and market their products.

Government actions affect the activities of firms in many ways, most them indirect. In the United States, in some contrast to other industrialized nations, Federal policies have seldom had the explicit intent of stimulating productivity or strengthening international competitiveness. Far more often, impacts on productivity have been side-effects of policies with other objectives. Although several provisions of the Economic Recovery Tax Act of 1981 have been among the exceptions, this is just as true in general for tax policies as it is for policies dealing with environmental protection or workplace safety. And of course, Government actions cover a wide spectrum: not only taxes and regulation, monetary and fiscal policy, but policies dealing with international trade, education and training, and national defense will all have their impacts.

The tax code affects some types of business decisions quite directly. One example, currently under debate, is the R&D tax credit, scheduled to expire in 1985. Venture capital supplies for entrepreneurial startups depend to considerable extent on tax treatment of capital gains. As this last example illustrates, the tax system does not affect productivity and competitiveness only through corporate taxes. Even so, corporate taxes are the most significant. Neither tax rates on personal income, nor the nation's savings rate -- historically low compared to most other economies -- can be linked directly to productivity.

Taken one at a time, most Federal policies have marginal impacts on productivity and competitiveness. Environmental standards imposed on the American steel industry, despite their high price tag in dollars, have not by themselves had much effect on competitive trends. To take a much different example, while the strong dollar has hurt U.S. exports over the last year or so, the shifts in competitiveness that OTA has analyzed in industries like steel or consumer electronics can be traced back to the 1960s. The patterns have persisted over many years and many fluctuations in macroeconomic climate.

Cumulatively, of course, the impacts of Government policies may be large. This has been the argument of those advocating widespread deregulation, or sweeping changes in tax policy such as a move toward value-added taxes or a flat tax. Most often, however, individual impacts have been random -- some positive, some negative, the overall picture mixed.

CORPORATE TAXES

Given the wide range of Government activities with effects on productivity, what is the relative importance of tax policies? Although a corporation's total tax bill will affect its cash flow position and hence the funds it has available for new investments or disbursements to shareholders, this question cannot be answered simply by comparing corporate tax rates in the United States with those in other countries.

In the late 1970s, the effective corporate tax rate in the United States averaged about 36 percent, that in Japan 29 percent. (The effective rate equals the total of all taxes paid by corporations divided by total corporate profits.) With the passage of the Economic Recovery Tax Act of 1981, effective rates in the United States have fallen far below those in Japan. This has encouraged investment, but it is still too early to say what the impacts on competitiveness will ultimately be -- in part because so many other forces have also been at work.

Of course, effective tax rates will vary across the sectors of the economy. The table below, taken from the 1982 Economic Report of the President (page 124), shows how large these differences can be.

	Effective Tax Rate, 1982 (Estimated)	
Sector	Under Previous Law	After 1981 Tax Act
Agriculture	32.7 %	16.6 %
Mining	28.4	- 3.4
Primary metals	34.0	7.5
Machinery and instruments	38.2	18.6
Motor vehicles	25.8	-11.3
Chemicals	28.8	8.6
Petroleum refining	35.0	1.1

Average (unweighted)	35.6 %	10.7 %

Note: The average includes a number of manufacturing and service sectors that have not been individually listed above.

These rates, which are estimates applying only to newly purchased assets, not actual payments, reflect the greatly accelerated depreciation schedules incorporated in the 1981 Tax Act.

As the table shows, this shift in U.S. tax policy greatly increased the spread in rates across sectors of the economy. One result, largely unintended but no less real, has been to shift the relative attractiveness of new investments in various economic sectors. Everything else the same, investments in refineries, for example, have become more attractive compared to investments in chemicals. Machinery and instruments, a sector that includes much "high technology," including electronics, fared poorly compared to the other sectors listed.

Still, this picture does not get us much closer to impacts on productivity and competitiveness. As the table indicates, the new depreciation rules treat the steel industry, a major part of the primary metals sector, quite favorably. As OTA's assessments have shown in detail, modernization of U.S. steelmaking capacity could yield substantial improvements in productivity. Yet little new investment in steel has been forthcoming. Why? Because other factors combine to reduce the relative attractiveness of such investments. Steel industry investment has been at low levels for many years, even during the 1950s and 1960s when profits were relatively high. Today, given substantial worldwide overcapacity in steelmaking, and an international trade regime quite unable to control subsidies and dumping, U.S. investments in integrated mills for commodity steel production have become even less attractive.

To probe such questions further demands an understanding of the internal workings of firms and industries: how business decisions are made; where investment capital comes from (internal versus external sources, debt of various types, new equity); how new products are developed. Often a firm-specific perspective is essential. Some integrated American steelmakers have diversified to the point that half their revenues come from non-steel activities. Other integrated firms have chosen not to diversify, but to concentrate their resources on relatively narrow market niches -- such as specialty steels -- where they can seek competitive advantages. Such decisions are conditioned by internal resources as well as external circumstance.

TAX POLICIES COMPARED TO OTHER FEDERAL POLICIES

But how does taxation compare to other Government actions as an influence on corporate behavior? To judge the relative impact of taxes, we must set the tax system against other influences on business decisions. Is tax policy more or less important than, say, the financing that governments provide for overseas sales through export-import banks? The Federal deficit, with its effects on interest rates and the value of the dollar? Federal R&D expenditures? To answer such questions takes industry-specific analysis if not firm-specific analysis.

The array of influences on corporate behavior can be a large one, as the table at the end of this statement illustrates. Examining the nine factors listed in that table shows immediately that the Federal Government can affect productivity and competitiveness through almost all. The first factor, industry and market structure, is the subject of antitrust enforcement. Federal policies toward education influence the characteristics of the labor pool. (OTA's analyses indicate that human capital is one of the most critical factors in determining competitive success.) Federal R&D policies, in addition to their direct impacts on sectors like aerospace and electronics -- which get the preponderance of contract funding for R&D -- affect the infrastructure for commercial technologies in many industries. I could go on down the list, but I think the point is clear: the impacts of Federal policy can only be judged in the context of the particular sector. While education and training will be important almost anywhere, in other cases Government policies will affect some industries much more than others. Trade policies, for example, have been far more central to competition in consumer electronics than in semiconductors.

Taxes, of course, enter the picture in many ways. Mortgage interest deductions, as well as capital gains provisions on home sales, may affect people's willingness to move to a new job -- not unimportant in an economy where high labor mobility has helped entrepreneurial industries, notably semiconductors, to thrive and grow. Income tax deductions for education and training expenses can make such programs more or less attractive -- with subsequent impacts on productivity. Corporate taxes, given the multitude of deductions and credits that a particular company can take advantage of, offer many more illustrations. The lesson is this: most of the impacts of the tax system on productivity are indirect. Most are also sector-specific and firm-specific. Individually, these impacts may be small. Cumulatively, they may be large in one industry but small in another. In the United States, the Federal Government has seldom looked to tax policy (or any other policy) as a tool for stimulating productivity. We have little experience in doing this, but a great deal of experience in the political compromises that go into the making of tax policy. If I may end with a question: Would it be realistic, given this history and given our political system, for the United States to now attempt, in self-conscious fashion, to use the tax code to stimulate productivity and competitiveness?

Influences on Industrial Competitiveness

(This table is a modified version of that on page 69 of the OTA report *U.S. Industrial Competitiveness: A Comparison of Steel, Electronics, and Automobiles*).

Factor	Examples
1. Industry and market structure	Number of firms, their size and market power, financial resources, production facilities, extent of vertical integration; industry concentration; market size, rate of growth, degree of saturation.
2. Blue and grey collar labor force	Labor costs; availability of skilled workers; Government support for training and education, including apprenticeships; incentives for internal corporate training programs; labor mobility, vertically as well as geographically; labor-management relations; work rules; mechanisms for employee participation, at corporate levels as well as on the shop floor.
3. Professional work force	Education and training of managers, engineers, and other non-production employees; attitudes and value structures, particularly of managers; characteristic approaches (e.g., in terms of risk taking) to developing, marketing, and exporting products; degree of interaction and cooperation among R&D, marketing, product planning, manufacturing engineering, and quality control personnel.

4. Availability of materials and components	Stability of costs and supplies for *inputs to the manufacturing process* (iron ore, petroleum, electronic components); domestic availability versus dependence on imports; quality; delivery schedules.
5. Supporting infrastructure	Transportation services; the physical infrastructure; *vendors, subcontractors*, and other suppliers, including those who provide services such as heat treating, equipment maintenance, or computer software, as well as capital goods; *basic research* organizations; Government support for military and *generic R&D*.
6. The environment for innovation and technology diffusion	Interactions and synergies among firms, within an industry and across national boundaries (mobility of personnel, licensing and other technical exchange agreements, openness to inward transfers of technology and management know-how); *clusters of knowledge and skills*, as among Silicon Valley semiconductor firms; *technology extension services*, such as many State Governments have begun establishing; patent and other intellectual property law.
7. Business and economic conditions	Overall economic prosperity as indicated conditions by GNP or GDP, levels of disposable income, inflation rates, productivity; costs of capital and *characteristics of financial markets*; less tangible factors such as consumer confidence, political stability, social welfare.
8. Government policies and interactions with the private sector	*Regulations* affecting factory work, design and sale of products, resource supplies, antitrust enforcement; *tax policies*; public sector procurement, especially military; less tangible factors including traditions of cooperation or conflict among Government, business, labor, and other interest groups.

9. International trade relations	Policies of domestic and foreign governments affecting imports and exports, including tariffs on imported goods and on re-imports after offshore assembly, quantitative restrictions and other non-tariff barriers, technology transfer policies, export credits and subsidies; policies affecting foreign investments, such as performance requirements and taxes on overseas profits; exchange rates; the role of international agreements and organizations such as the General Agreement on Tariffs and Trade in providing a policy framework and mechanisms for dispute resolution.

Senator GRASSLEY. Can you answer that last question?

Let me ask it another way: In your 5 years of study, have you even come to the conclusion of whether or not we ought to be more concerned with the Tax Code affecting productivity than we have before?

You have stated in your testimony that that probably has not been a primary concern most of the time; it's been a secondary concern. And various directions of the tax codes through specific legislation have been for other purposes.

Do you have a feel on the extent to which productivity ought to be a very primary concern?

Dr. ALIC. I think it should be a primary concern, Mr. Chairman. I think that it's easy to oversimplify impacts of taxes on productivity and jump to conclusions concerning what the impacts in the future will be. And I think that's one of the sources of my concern over the thought of using the tax system in a relatively self-conscious way to exert influence over the economy.

I think that it would be very difficult to do that and to reach the objectives that we might set for our economy.

Senator GRASSLEY. Could you generalize on whether or not the more complicated the tax code becomes—let's just say as you might measure it in size, of the volumes, you know. There may be other ways you ought to measure it as well, but that's one. The pyramiding of credits, the treatment of special aspects of the industry to the exclusion of others, whether those things in and of themselves have inhibited productivity? I mean from your 5 years of study, now. And I know you have been very specific in your studies, but as you might put those all together and make some generalities?

Dr. ALIC. I cannot point to compelling examples of that sort of impact. I think they are there, and I think if one looked for them one could find examples.

Generalizing, because of the great number of ways in which Federal actions impact productivity, generalizing from the examples of positive or negative effects of certain facets of the Tax Code to productivity in the economy as a whole I think is risky.

Senator Grassley. Have any of your studies in the last 5 years given specific recommendations on changes in the Tax Code directly related to productivity? I assume you have addressed a lot of other issues other than productivity in these studies, but have they given specific recommendations as it relates to just what you see as ways of enhancing productivity?

Because I would be right in assuming that the enhancement of productivity would never be a negative as far as any of the studies you have made on the Tax Code, right?

Dr. Alic. Certainly productivity is very important to competitiveness and is always a positive factor in competitiveness.

I need to preface my response to your question by noting that OTA does not make recommendations. Our role is to perform analysis in support of congressional decisionmaking.

Senator Grassley. Does that preclude you, then, from answering my question?

Dr. Alic. I can answer your question as long as I don't use the words "we have recommended" such and such.

Senator Grassley. All right. Go ahead.

Dr. Alic. We have certainly noted ways that the Tax Code has affected productivity and competitiveness, and the major impact I have pointed to is, since our concern is the future and not the past, the effect of the 1981 Tax Act in changing the relative ability of firms in various sectors of the economy to attract capital.

The changes in effective tax rates in the 1981 Tax Act, according to our analysis, have put, for example, high-technology industries such as electronics at a relative disadvantage, simply because their taxes went down less than those of many other sectors of the economy. Particularly, they went down much less than some of the heavy industries and the automobile industry.

Even though in absolute terms the electronics industry saw its taxes reduced, with benefits as well from the R&D tax credits and deductions for donations of scientific equipment to universities, compared to other sectors of the economy, it did not come out so well.

We believe that it is necessary to look at differential impacts of Federal policy across sectors of the economy in order to evaluate impacts, and to us that shift in differential impact has been one of the primary effects.

Senator Grassley. What is the perception, as the result of your studies over the last 5 years—and it is my understanding that, as it deals with the international competitiveness of our sector, you would have to also then be concerned about other countries and their policies—to what extent in a very general way are the parliaments of other free societies more concerned about how the Tax Code affects productivity than, as you understand the United States, we would be concerned about that?

I am talking about on a list of priorities, you know. You say we have several priorities, and you generalize that productivity is much a second concern as far as the Congress of the United States is concerned. Are other parliaments and policymakers and tax laws much more concerned about the Tax Code affecting productivity than we are?

Dr. Alic. Yes, Mr. Chairman, I think they are. We have looked quite extensively at Government policies in several of the Western European nations, in Japan, and in some of the newly-industrializing countries. Many of these Governments use the tools available to them, including the Tax Code, as instruments—the term is "industrial policy" in many foreign countries—as instruments to stimulate productivity and competitiveness, to support the industries that they see as the engines of economic growth that will take them into the next century. They do that in a much more coordinated fashion than the United States has.

Of course, in doing so they have different sets of tools to work with—laws, regulations, political traditions, and forms of government.

Senator Grassley. In regard to other parliaments of the free world and their industries, do you generally find that the Tax Codes of these foreign countries are less complicated than ours? So that the Tax Code then would be more neutral in the sense that I meant it in my opening statement—more neutral and decisions made more on the economics of the investments than in the United States? Or are their Tax Codes as complicated, so that the business managers of those corporations have the same complicated considerations we do?

Dr. Alic. I would say, by and large the Tax Codes of other countries are very complicated. I would be reluctant to say they are as complicated as ours or more complicated than ours. We have not made a study of that. But they are complex.

The primary difference we see is that foreign governments that use their Tax Codes to stimulate productivity do so precisely by making use of special rules—exceptions, exclusions, tax benefits for sectors that they single out for support.

So, in a sense, they are making use the complexities available to them through their own tax laws as instruments, at the microeconomic level. That is something I think we have been reluctant for good reason to consider in this country.

Senator Grassley. On the other hand, though, those of us in the Congress, in almost every specific tax act, or credit, or whatever we do in the Tax Code, I think it is uppermost in our mind that we are trying to do it to affect productivity. Maybe there are some narrow social gains we would expect to accomplish, but I think we would think in terms of doing something good to encourage productivity.

Let's take an example. Even when I had the targeted jobs tax credit for 16- and 17-year-olds for summer employment, there was the social good of having people work in the summer instead of being on the streets. But I honestly feel in my heart that if I can provide a job for a teenager for the summer and get him that first job, we are probably going to have better vocational education for that person than anything we can do through the educational system. And I think getting people used to the work ethic is contributing to the productivity of our economy.

Now, you could read that in the Congressional Record; I could say the same thing there. But I just wonder if the generalizations that you make about other free world parliaments vis-a-vis the Congress, if it is based upon your firm conclusion that they really have productivity at a high level of consideration as they develop their Tax Code, or whether that is a perception you might get from statements by their politicians, as you might come to the same conclusion about the U.S. Congress if you listened just to our debate.

Dr. **Alic**. I would say that in many foreign countries it is not a matter of devising a Tax Code with the objective of stimulating productivity; it is a matter of making use of the opportunities available in the existing tax law on a case-by-case basis to try to reach relatively narrow objectives. I think all Governments do that.

I think we see more evidence——

Senator **Grassley**. But they do it better than we do, basically, is your conclusion to my question a couple of questions ago, right?

Dr. **Alic**. I would say that Japan does it somewhat better than we do. I would be reluctant to reach that conclusion about the European countries. Their attitude, in some cases, has been more self-consciously experimental than ours in using the Tax Code in a microeconomic way over the last half dozen years.

Senator **Grassley**. All right.

Did you finish your statement when I interrupted you with my followup question?

Dr. **Alic**. Yes.

Senator **Grassley**. Well, I think that is the end of my questions for you. I suppose that you would encourage us to look in greater depth at some of your 5 years of work in this area, that you feel that any committee looking at productivity in the Tax Code would benefit from the work you have done in these areas, even though you were looking narrowly at the competitiveness of the U.S. industries versus foreign industries.

Dr. **Alic**. I would hope so, Mr. Chairman, Thank you.

Senator **Grassley**. Thank you very much, Dr. Alic.

Dr. **Alic**. Thank you.

Senator **Grassley**. Now I have the pleasure of calling a panel of very distinguished people, some of whom have testified many times before my subcommittee, some who may be here for the first time whom I have also known for a long period of time, and then some who are here to meet me for the first time.

So, whether you are an old hand at testifying before my committee or whether you are here for the first time, I want to say thank you very much for coming.

We have Dr. John Kendrick, director of the project on productivity with the American Enterprise Institute; Donald C. Alexander, Morgan, Lewis & Bockius, a law firm here in Washington, DC; Howard Phillips, who is chairman of the Conservative Caucus, Inc., Vienna, VA; and the Honorable Floyd K. Haskell, former U.S. Senator from Colorado. Senator Haskell, you list your address as Washington, DC?

Senator **Haskell**. That is correct, Mr. Chairman.

Senator **Grassley**. Thank you.

And Philip Storrer, professor of accounting, California State University.

Now, is it Dr. Kendrick that is not here? Does anybody know anything about Dr. Kendrick?

[No response.]

Senator GRASSLEY. I guess, then, I would ask Donald Alexander, then Howie Phillips, then Senator Haskell, and then Philip Storrer. That was the way in which I introduced the panel.

STATEMENT OF DONALD C. ALEXANDER, ESQ., MORGAN, LEWIS & BOCKIUS, WASHINGTON, DC

Mr. ALEXANDER. Thank you, Mr. Chairman.

I am Donald Alexander, and I have a statement which I would like to have put in the record; I won't read any of it to you.

Senator GRASSLEY. Yes, it will be included.

In the case of all of you who have a longer statement, we would ask you to summarize, and they will be included in toto in the record.

Mr. ALEXANDER. Mr. Chairman, in your letter of June 4 to me you stated that you were going to focus on patterns which would enable the Congress to propose changes to make our code, overburdened and overlong and unrivaled, by the way, by any other tax code of any other country, simpler, fairer, and more neutral. That's exactly what we need.

We need an Internal Revenue Code that is comprehensible to the human mind, if possible. We need a fairer code. And we need a more neutral code. And that is not what we have at this time.

I looked back at the figures on page 10 of Dr. Alic's statement, and you see the variances to which you referred and which he discussed. That is not the direction that we are going in the 1984 act. We are going to add perhaps 800 pages by the time we get through to a code that is already so long has to defy human understanding.

Now, the White House Conference on Productivity, on which I served, reviewed the very issue that concerns you and found that our current tax system distorts incentives for capital formation, saving, research, development, and productive enterprise.

There was a consensus for reducing tax rates and also for eliminating double taxation of income.

I would like to read one short paragraph to you from the White House Conference on Productivity's recommendations:

> In addition, there was sentiment in favor for a moratorium on enacting new tax legislation until a plan for fundamental reform could be established. Piecemeal approaches to providing new initiatives, closing loopholes, or raising smaller amounts of additional revenue tend to increase the distortions in the system and have an adverse effect upon productivity-enhancing behavior. Moreover, the myriad of current proposals for legislation will add complexity to the system and may contribute further to the general perception of inequity and inefficiency in our tax system.

Now, that general perception of inequity, efficiency, and unfairness, is a matter on which there has been considerable publicity lately by reason of the road show that the Treasury has been engaged in. They are going out to hear what ordinary people have to say about the tax system. They are finding that ordinary people don't understand it and don't like it.

Now, the tax system depends on both perception and reality. The reality is that we try to do too much with it, that we build too many incentives into it on the grounds that a particular incentive is needed to serve a particular purpose at a particular time.

But if A gets an incentive, then B is going to demand one next year before the Congress, and C, and the rest of the alphabet can make compelling cases—not by reason of what the system was before A's incentive was built into it, but by reason of what the system became after we started using the system in a nonneutral way and other than as a system to try to raise revenues.

Let's go back and use our tax system to raise revenues. Let's reduce rates and broaden the base.

Senator **Grassley**. All right.

Howie, you are next.

[Mr. Alexander's written prepared statement follows:]

STATEMENT OF
DONALD C. ALEXANDER

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
FINANCE COMMITTEE
U. S. SENATE

CONCERNING

PRODUCTIVITY AND TAXES: FUNDAMENTAL PROBLEMS

JUNE 18, 1984

My name is Donald C. Alexander and I am a partner in the law firm of Morgan, Lewis and Bockius. I appreciate the opportunity to testify before the Subcommittee, purely in my personal capacity, on what I believe to be some adverse effects of the existing federal income tax system on U.S. business.

The decline in the rate of U.S. productivity growth relative to that of our economic competitors has begun to threaten the status of the United States as the world economic front-runner. While there are probably as many theories for this as there are theorists, there may be little question that the tax system is at least partially to blame. What is needed is a system that is as neutral as possible across alternative uses of time, capital and human resources and that encourages -- or at least does not discourage -- capital formation, technological innovation and long-term investment, particularly in emerging growth companies. Moreover, the rules should be rational and clear and there should be few enough of them to permit businesses to plan transactions with confidence in the results and without the need for expensive professional assistance at every step. What we have falls far short of the ideal.

Over the years, the tax system has increasingly been pressed into service as a means of influencing patterns of economic activity, with the result that the Internal Revenue Code now bulges with deductions, credits and exclusions intended as business incentives. However, a "squeaky wheel" approach has often been taken in response to business needs, resulting in uneven distribution of benefits across the business spectrum.

One indication of this is the actual operation of the corporate income tax. While the statutory marginal rate is 46%, a study of representative companies conducted by the Joint Committee on Taxation last fall showed that the average effective rate for all companies included in the study for 1982 was 16.1 percent on U.S. income and 29.6 percent on worldwide income, with wide disparities in the effective rates of tax on U.S. income by various industries. Rates ranged from negative percentages for certain industries to over 30 percent for food processing, paper, pharmaceuticals, wholesaling and trucking. The rubber industry was highest with 39 percent. Close to the average were the beverage industry (20.5 percent), construction industry (15.9 percent), investment companies (21.3 percent) and retailing industry

(20.4 percent). See Study of 1982 Effective Tax Rates of Selected Large U.S. Corporations, Joint Committee on Taxation (Nov. 14, 1983), p. 11.

While great caution must be exercised in drawing conclusions from such data, it may be safe to say that the current tax system seems to be doing much for some and little for others.

The problem of capital formation in basic industries has been ameliorated to some extent by ACRS and the reinstitution of the investment tax credit, although the business community continues to be concerned that the TEFRA cutbacks in those incentives may have weakened prospects for full recovery. However, in light of such phenomena as the growth of the equipment leasing industry, one might question whether this approach may have done more to introduce distortions into the system than to meet the capital needs of basic industries. In any event, while ACRS may result in substantial tax savings and increased cash flow with respect to investment in long-lived plant and equipment, this is of little use to many segments of the economy. High technology companies contend that to keep pace with their foreign and domestic competitors, they tend to replace plant and equipment frequently and prior to their economic obsolescence. Moreover, these capital formation incentives do not help the labor-intensive service industries.

Clearly there are other ways in which existing federal tax policies tend to favor some business taxpayers over others. The pace of technological innovation, in the U.S. and abroad, has greatly increased the cash needs of high technology companies for research and development expenditures. While the tax credit approach taken by TEFRA may have equalized the treatment of R&D-intensive and capital-intensive industries to some extent, some forms of R&D are more equal than others under the new rules.

A related problem, which all industries share, is that many business incentives are now provided in the form of credits. Many companies, particularly emerging companies, may have no tax liability and thus no use for credits.

I believe that the approach taken in the past to the cash, capital and investment needs of U.S. business should be reconsidered. Isn't the best course a broadening of the tax base and an across-the-board reduction in tax rates? Of course, this would require that some businesses give up hard-won and jealously-guarded deductions, credits and exclusions. However, an across-the-board rate reduction would reduce the need for these. Moreover, the benefits to be derived by simplifying the system may outweigh the value of preferences for many business taxpayers. The complexity of the existing system is enormously costly to American business. In addition to the expense of tax planning advice and return preparation, the volume of reporting and recordkeeping required of businesses is enormous and expensive. Also, audits are expensive, whether or not they result in an increase in tax liability, insofar as they tie up staff and usually require at least some assistance from outside advisers.

Given the complexity of modern economy, it may be impossible for a system of business taxation to be simplified to the point of putting most tax practitioners and revenue agents out of business. Nonetheless, I think some existing business preferences should be reconsidered, thereby permitting rate reductions that should ultimately benefit everyone.

STATEMENT OF HOWARD PHILLIPS, CHAIRMAN, THE CONSERVATIVE CAUCUS, INC., VIENNA, VA

Mr. PHILLIPS. Senator, thank you very much for holding these hearings and for giving me the opportunity to testify on behalf of the conservative caucus.

Revenue from the corporate income tax for fiscal year 1985 has been estimated at approximately $76.5 billion by the Office of Management and Budget. This compares with approximately $328.4 billion in revenue expected from personal income taxes in 1985.

Taxes on corporations have long been a politically popular method for raising revenue. As has been observed, corporations do not vote—people do. Corporate taxation also appeals to sentiments of envy and greed, permitting politicians to parade as altruistic philanthropists using corporate receipts to aid constituents they declare to be deserving.

The truth is, however, that the corporate income tax does do harm to people: First, it is regressive in its impact; second, it discourages productivity and efficiency; third, it promotes the agglomeration of corporations; fourth, it increases consumer prices; fifth, it hurts small business; sixth, it discourages investment; and seventh, it distorts the market.

The corporate income tax facilitates a massive system of corporate welfare, punishing the most productive corporations by extracting more taxes from them, and using those taxes to reward less efficient companies with subsidies, grants, loans, and loan guarantees, helping them compete directly and oftentimes successfully against the more productive.

Corporate taxes are regressive. The tax demands of Government on business are borne not only by stockholders and managers, extra costs are also absorbed by raising prices, keeping wages down, hiring fewer employees, and/or laying off those already on the payroll.

Because lower income people are assumed to spend a greater proportion of their income on the basic necessities for living, price increases resulting from corporate income taxes tend to fall more heavily on them and can thus be characterized as "regressive."

The corporate income tax reduces the growth of worker pension plans by removing much of the pension funds' accumulation before dividends are paid. As Peter Drucker has observed in his book "The Unseen Revolution," the corporation income tax:

> has thus become a highly regressive tax and one that is paid increasingly by the employees, especially those least able to afford a high rate of taxation—older retired workers. It is, in effect, a tax to soak the poor.

The corporate income tax requires productive enterprises to surrender capital that could be reinvested. Without this capital fewer jobs can be sustained, while pay levels are affected adversely for those employees who can be retained.

Corporations pay taxes on their profits, and then shareholders must pay tax again on the amount distributed to them as dividends. This double taxation is both unfair and destructive of economic growth. Removal of the corporate tax would allow profits to be taxed only once to the shareholders, at their individual rates.

Corporate taxation encourages business concentration and discourages the development of competition from struggling new enterprises.

Milton Friedman has pointed out that internal reinvestment by corporations, while possibly creating tax advantages for stockholders, artificially directs investment decisions away from market indicators. Large corporations can shift their internally generated funds from division to division, diversifying and raising their stock value, which allows them to attract borrowed funds at lower interest rates. Small businesses which need capital desperately are not able to compete against large concerns better situated not necessarily to produce but to take advantage of the tax system.

With the elimination of the corporate income tax, corporations could concentrate their efforts on maximizing profits, not on evading taxes. America would be a wealthier, more productive nation.

The $76.5 billion that the U.S. Treasury expects from corporations in fiscal year 1985 should be allowed to stay where it would otherwise be, in the working capital of those corporations.

Instead of leaving capital investment decisions to the individual corporations and to the market where decentralized decisionmaking enhances productivity and efficiency, Congress has been taking the money to Washington. Abolition of the corporate income tax would obviate the necessity for the investment tax credit, depletion allowances, and numerous other shelters and credits designed to buffer the blows of corporate tax requirements. These so-called "tax advantages" result in corporations making investments and business decisions with the goal of reducing tax liability rather than focusing on increased productivity, efficiency, and profits, which would result in more jobs and higher wages, not to mention wiser investments.

If the corporate income tax were to be abolished, how would the Government make up for the $76.5 billion loss in revenues?

First, since all profits will be taxed to the shareholders, some of the $76.5 billion in taxes previously paid by corporations might then be paid by individual taxpayers.

Second, the elimination of the corporate tax would let the success pattern of the free market replace the inefficiency of Government planning and regulation. This, too, can add to revenues by producing more jobs and more affluent taxpayers.

Third, and most important, the estimated $76.5 billion in revenue loss could be significantly offset if the Federal Government would eliminate big business, big bank, and big labor corporate welfare subsidies.

The Conservative Caucus Foundation is now preparing a study of proposed program savings which will be submitted to the committee at a later date.

Thank you, Mr. Chairman.

Senator **Grassley**. Thank you, Howie.

Senator Haskell?

[Mr. Phillips' prepared statement follows:]

June 18, 1984

Statement by Howard Phillips
Chairman
The Conservative Caucus, Inc.
450 Maple Avenue East
Vienna, Virginia 22180

Presented to the
Subcommittee on Oversight of the Internal Revenue Service
Committee on Finance
United States Senate

Mr. Chairman. Members of the Committee.

Revenue from the corporate income tax for Fiscal Year 1985 has been estimated at approximately $76.5 billion dollars. This compares with approximately $328.4 billion in revenue expected from personal income taxes in 1985.

Taxes on corporations have long been a politically popular method for raising revenue. As has been observed, corporations don't vote; people do.

Corporate taxation also appeals to sentiments of envy and greed, permitting politicians to parade as altruistic philanthropists, using corporate receipts to aid constituents they declare to be deserving.

The truth is, however, that the corporate income tax does do harm to people: 1) it is regressive in its impact; 2) it discourages productivity and efficiency; 3) it promotes the agglomeration of corporations; 4) it increases consumer prices; 5) it hurts small business; 6) it discourages investment; and 7) it distorts the market.

The corporate income tax facilitates a massive system of "corporate welfare," punishing the most productive corporations by extracting more taxes from them, and using those taxes to reward less efficient companies with subsidies, grants, loans, and loan guarantees, helping them compete directly and successfully against the more productive.

Corporate taxes are regressive: the tax demands of government on business are borne not only by stockholders and managers, extra costs are also absorbed by raising prices, keeping wages down, hiring fewer employees, or laying off those already on the payroll.

Because lower-income people are assumed to spend a greater portion of their income on the basic necessities for living, price increases resulting from corporate income taxes tend to fall more heavily on them, and can thus be characterized as regressive.

The corporate income tax reduces the growth of worker pension plans by removing much of the pension fund's accumulation before dividends are paid. As Peter Drucker observes in his book, The Unseen Revolution, "The corporation income tax has thus become a highly regressive tax, and one that is paid increasingly by the employees, especially those least able to afford a high rate of taxation--older retired workers. It is in effect a tax to 'soak the poor.'"

The corporate income tax requires productive enterprises to surrender capital that could be reinvested. Without this capital, fewer jobs can be sustained, while pay levels are affected adversely for those employees who can be retained.

Corporations pay taxes on their profits, and then shareholders must pay tax again on the amount distributed to them as dividends. This double taxation is both unfair and destructive of economic growth. Removal of the corporate tax would allow profits to be taxed only once--to the shareholders at their individual rates.

Corporate taxation encourages business concentration and discourages the development of competition from struggling new enterprises. Milton Friedman has pointed out that internal reinvestment by corporations, while possibly creating tax advantages for stockholders, artificially directs investment decisions away from market indicators.

Large corporations can shift their internally-generated funds from division to division, diversifying and raising their stock value, which allows them to attract borrowed funds at lower interest rates. Small businesses which need capital desperately are not able to compete against large concerns better situated not to produce, but to take advantage of the tax system.

With the elimination of the corporate income tax, corporations could concentrate their efforts on maximizing profits, not evading taxes. America would be a wealthier, more productive nation.

The $76.5 billion that the U.S. Treasury expects to extract from corporations in FY85 should be allowed to stay where it would otherwise be--in the working capital of those corporations.

Instead of leaving capital investment decisions to the individual corporations and to the market, where decentralized decision-making enhances productivity and efficiency, Congress has been taking the money to Washington.

Abolition of the corporate income tax would obviate the necessity for the investment tax credit, depletion allowances, and numerous other shelters and credits designed to buffer the blows of corporate tax requirements. These so-called "tax advantages" result in corporations making investments and business decisions with the goal of reducing tax liability, rather than focusing on increased productivity, efficiency, and profits, which would result in more jobs and higher wages--not to mention wiser investments.

If the corporate income tax were to be abolished, how would the government make up for the $76.5 billion loss in revenues?

First, since all profits will be taxed to the shareholders, some of the $76.5 billion in taxes previously paid by corporations might then be paid by individual taxpayers.

Second, the elimination of the corporate tax would let the success pattern of the free market replace the inefficiency of government planning and regulations. This too could add to revenues by producing more jobs and more affluent taxpayers.

Third, and most important, the estimated $76.5 billion in revenue loss could be significantly offset if the Federal government would eliminate big business, big bank, and big labor "corporate welfare" subsidies.

TCCRAEF is now preparing a study on proposed program savings which will be submitted to the committee at a later date.

STATEMENT OF HON. FLOYD K. HASKELL, FORMER U.S. SENATOR FROM THE STATE OF COLORADO, WASHINGTON, DC

Senator HASKELL. Thank you, Mr. Chairman, I appreciate the opportunity to be here.

I think you are bringing before the public a very important issue—productivity—and I congratulate you.

Productivity, and I believe we would get consensus on this definition, means the flow of labor and capital in a free market to its most efficient use.

Now, if we have agreement on that proposition, then any barrier to that free flow of capital reduces productivity.

I'm sure all of us here in this room realize that our tax laws are full of barriers, artificially channeling capital and labor in various and sundry ways. The fault is bipartisan; it's not Republican, it's not Democrat, it's both.

The examples of these barriers are far too numerous to enumerate. However, I would like to mention two principal barriers: One you can lay at the doorstep of the Democrats; the other we can lay at the doorstep of the Republicans. These are the so-called fast depreciation, accelerated depreciation, now called ACRS; and the other one is the investment tax credit.

The Federal Reserve Board in April of 1981 published a study which showed that these two skewed investment to short-lived assets. The net result was that more capital went into mere replacements rather than to the expansion of the investment base, leaving, in the words of the Fed, "less available for net capital formation."

Then, as your committee has brought out and as has been in the press lately, the so-called incentives designed to help an industry often hurt an industry—and I am specifically referring to agriculture, which has been very widely reported and I presume as a result of your hearing.

Then there are additional distortions that take place. For example, Jack Carlson, chief economist of the realtors, is quoted in the New York Times of March 19, as saying that, if the depreciation on buildings goes to 20 years as opposed to 15 years, then a building now worth a million will suddenly be worth only $750,000.

Well, I think we all know that useful lives of structures far exceed 20 years, and I would suggest that if useful-life depreciation was used Mr. Carlson might say the building would be worth only $400,000. So economies are distorted and capital and labor misdirected.

I would suggest, Mr. Chairman, that if these barriers could be eliminated and income, as the owners of a business look at income, taxed, then the tax laws become neutral. There would be no artificial channeling of labor on capital one way or another.

And under these circumstances, as Mr. Alexander pointed out, clearly rates could be reduced substantially. I think the Nation as a whole would benefit.

Again, I thank you very much.

[Senator Haskell's prepared statement follows:]

STATEMENT OF FLOYD K. HASKELL ON THE RELATIONSHIP OF OUR TAX SYSTEM TO PRODUCTIVITY

Mr. Chairman and Members of the Subcommittee, my name is Floyd K. Haskell. I am chairman of the Taxpayers Committee, a non-partisan, non-profit organization, devoted to the study and reform of our tax laws. I am a former member of the Finance Committee and, as a member, was chairman of this subcommittee. For the previous twenty years, I was in private law practice, specializing in tax law.

The subject of this hearing—the relationship of our tax laws to economic productivity—is one that has been long neglected. I congratulate the chairman for bringing the subject to public attention by scheduling these hearings.

Productivity is attained by allowing investment to flow, in a free market, to wherever it can get its greatest return. Barriers to this free flow automatically reduce productivity in our nation.

To preserve this free flow, our tax laws should be neutral. The income that is subject to tax should be real income—the income that the owners of a business look to, the income statement demanded by a banker. Anything short of this will artificially divert capital and labor, thus frustrating the free market.

Our tax laws are about as far from this ideal as it is possible to get. Our tax system is a hodge-podge of exceptions, special benefits, "incentives"—call them what you will—that are barriers to productivity. We believe in the free entreprenurial system, except, it seems, when it comes to taxes.

In our tax code, we attempt to plan our economy. And the economy suffers. Productivity suffers.

Examples are too numerous to be cited in any detail here, but I will mention two—the first a major Republican mistake, the second can be laid on the doorstep of the Democrats. These are accelerated depreciation, adopted in 1954 in the Eisenhower Administration, and the investment tax credit enacted in 1962 when John Kennedy was president.

These socalled incentives, not only give certain industries a distinct advantage over others, but have had a measurable adverse effect on the economy as a whole.

The Federal Reserve addressed itself to the question of capital formation and, in 1981, published an exhaustive study of the question. The Fed's conclusion was that accelerated depreciation and the investment tax credit had induced investment in short-lived, as opposed to long-lived, assets. As a result, the nation used increasing amounts of capital merely to replace assets that had worn out. The result, in the words of the Fed, was less capital "available for net capital formation".

Furthermore, basic industries are often damaged by the very "incentives" which are meant to help them. Witness the farm sector which has been the subject of considerable press in the last few weeks.

As we all know, the tax return on an investment is unrelated to its economic return. Socalled "incentives" affect investment flow and market values, often creating unrealistic market values.

For example, Jack Carlson, chief economist for the National Association of Realtors, is quoted in the New York Times of March 19. Mr. Carlson laments the increase of depreciation of real estate from 15 years to 20 years—and we all know that twenty years for real estate is far short of its useful life.

Mr. Carlson says that, assuming this provision survives conference, a building now worth one million will drop to $750,000. If economic depreciation were applied, this mythical building might sell for $400,000—so does the tax law distort economics.

In conclusion, Mr. Chairman and members of the Committee, if the Congress is serious about productivity, the special benefits must be repealed. Tax law should become neutral, taxing economic income. Investment will then flow to where it can get the highest economic return. Optimum productivity will thus be attained.

Senator GRASSLEY. I think the different views we have here from people coming from different political philosophies are ending up at about the same place. And I think this sort of recognition is what we have to build upon to bring about a change in the Tax Code, so that you have decisions based on the economics rather than on the Tax Code.

Mr. Storrer?

STATEMENT BY PHILIP P. STORRER, PROFESSOR OF ACCOUNTING, CALIFORNIA STATE UNIVERSITY, HAYWARD, CA

Mr. STORRER. Mr. Chairman, my name is Philip Storrer. I would like to thank you for this opportunity to participate in this most important process. I also want to commend you for these hearings and also other actions indicative of your insight into the problems created by our tax system for American business.

I am representing myself. I am a professor of accounting and taxation at California State University in Hayward, where I have been for the last 11 academic years. During that time I also practiced as a CPA and conducted seminars for tax professionals around the country. Prior to that time I spent 4 years with the Internal Revenue Service as an agent, an instructor, and a manager.

Businesses must deal with governmental regulations as a regular and pervasive part of conducting their activities. American business has developed an efficient means of so doing. In short, business people can and do contend with a great deal of governmental intervention, but they cannot cope effectively with uncertainty.

The Federal Income Tax system is full of technical and procedural complexities which defy comprehension and create growing uncertainties.

In the words of an ex-Internal Revenue Service Assistant Chief of the Examination Division, now in private practice as a CPA in Los Angeles:

> Tax planning is not possible in the current environment, with one monumental tax change after another. Internal Revenue Service agents cannot be adequately trained, and we as tax advisors cannot stay current.

TECHNICAL UNCERTAINTIES

I think it is quite simple to demonstrate the adverse affect of the technical complexities of our tax law. Since 1969, Congress has enacted 159 different public laws modifying various parts of the Internal Revenue Code. Forty-seven of these have been passed since 1980. As a result, private sector tax professionals are in a perpetual state of confusion regarding not only the proper interpretation of the various Code provisions but effective dates of implementation, revocation and phaseout of others. I also think the backlog of Treasury regulations, stands as a monument to this uncertainty. During the month of March of this year, the backlog of projects was reduced by a net of only four, from 381 to 377. Many of these regulation projects interpret provisions that are vital to business decisions. Some of them like section 385 regulations, have been on the drawing boards since 1969.

In recent years the Internal Revenue Service has adopted several technical and procedural positions which have resulted in congressional moratoria, instructing the Service to modify or suspend rulings or regulations pending congressional review. These moratoria affect fundamental business areas such as fringe benefits, commuting rules, independent contractor status. Congress has been intending to resolve these issues since 1976 in the case of the first two, and since 1978 in the case of the last. And in the meantime, business people must make decisions having to do with these unresolved areas.

The logjam of court cases also pays tribute to the problem of technical complexity. Timely judicial interpretations are a thing of the past.

I think it is just as important to concentrate on Procedureal uncertainties, if not more important than technical uncertainties. The Internal Revenue Service has, in my opinion, without question, an enviable record of tax administration. In fact, I believe that perhaps the Internal Revenue Service has become a victim of its own success; because of this success the IRS is called upon to satisfy all kinds of problems not necessarily dealing with the production of revenue and collection of same.

We point with pride at our country's high level of voluntary compliance, for which I believe the Service deserves much of the credit. But recently, we have seen a growing revolt among the people who rebel against a system that they cannot understand and with which they cannot adequately cope.

Current concern in many quarters of the IRS at the management level involve the implementation of what is called "must work," in things like abusive tax shelters, tax protestors, and more importantly in my opinion, the pervasive underground economy.

To illustrate their concern, Revenue Procedure 83-78: The Internal Revenue Service under that procedure is notifying investors in abusive tax shelters of an impending audit. The concern in some of the key districts is how to carry out that promise to audit: They do not have enough manpower to deliver on their promise. So they have, in the words of some managers "an effective weapon, but no delivery system." The mountain of technical provisions is clearly illustrated by the Internal Revenue manual, which is nine volumes thick and 9,000 pages long.

I also observe in connection with procedural uncertainties, that there are diseconomies of small scale business. I know my time is up, so I would like to conclude simply by suggesting that the diseconomies of small-scale business are there, that small-scale businesses cannot deal adequately with the Tax Code. Large-scale businesses deal more effectively with it.

I would like to quote an ex-Internal Revenue Service group supervisor who is now practicing as a certified public accountant:

> I cannot believe how screwed up the system is. When I was with the Service, we thought that the problems were the exception. Now that I am out, I see that they are the rule. Other ex-Internal Revenue Service agents and managers share my feelings. You never know exactly what they are going to do, so it makes us look like idiots.
>
> I have been amazed since I have been out of the Service at how screwed up they are, and it is getting worse, not better.

I believe that the broad-based tax approach is the proper one, and I have submitted for the record appendix A, which consists of testimony previously submitted before House Ways and Means advocating a broad-based gross income, value-added type consumption tax, that kind of system, for implementation.

I have also included as exhibit A a sample tax form format that could be used to simplify the administration. I am convinced that is absolutely critical to make the form simple in connection with an alternative tax system.

In conclusion, I would like to relate a humorous message given to me in 1978 by the then chairman of our accounting department at California State University in Hayward when he learned that I was to be testifying before the House Ways and Means Committee on the 1978 Revenue Act. He said, "Phil, please tell them to reform the tax laws so that the average CPA with a doctorate in accounting can understand it."

Hearings such as this are very important and a large step in the right direction, and I commend the chairman for the courage.

Thank you very much.

Senator GRASSLEY. Thank you.

[Mr. Storrer's written prepared statement follows:]

STATEMENT OF PHILIP P. STORRER
PROFESSOR OF ACCOUNTING AND TAXATION,
CALIFORNIA STATE UNIVERSITY HAYWARD, CALIFORNIA
PREPARED FOR HEARINGS ON PRODUCTIVITY AND THE TAX SYSTEM
JUNE 18, 1984
HEARINGS BEFORE SENATE FINANCIAL COMMITTEE
THE HONORABLE CHARLES E. GRASSLEY, CHAIRMAN

Uncertainty Of The Tax System And Its Effect On Business Particularly Small Business

Background

Businesses must deal with governmental regulation as a regular and pervasive part of conducting their activities. American business has developed an efficient means of so doing. In short, businesspeople can and do contend with a great deal of governmental intervention, but they cannot cope effectively with uncertainty.
The Federal Income Tax System is full of technical and procedural complexities which defy comprehension and create growing uncertainties . In the words of an Ex-Internal Revenue Assistant Chief of the Examination Division, now in private practice as a Certified Public Accountant:

> "Tax planning is not possible in the current environment with one monumental tax change after another. Internal Revenue Service agents cannot be adequately trained; and we, as tax advisors, cannot stay current."

Technical Uncertainties

It is quite simple to illustrate the adverse effect of the technical complexities of our tax laws. Since 1969, Congress has enacted 159 different public laws modifying the Internal Revenue Code. Forty-seven of these have been passed since 1980. As a result, private sector tax professionals are in a perpetual state of confusion regarding not only the proper interpretation of various code provisions, but effective dates for implementation of new sections and phase out of old ones.

The backlog of Treasury Regulation projects continues to stand as a monument to this uncertainty. During March of this year the backlog of projects was reduced by a net of 4 from 381 to 377. Many of these projects interpret provisions vital to business decisions. Some such as the section 385 Regulation Project, recently withdrawn in frustration, have been on the drawing board since 1969.

In recent years the Internal Revenue Service has adopted several technical and procedural positions which have resulted in congressional moratoria instructing the service to modify or suspend rulings, and regulations pending congressional review. These moratoria effect fundamental business areas such as fringe benefits, commuting rules, and independent contractor status. Congress has been intending to resolve these issues since 1976 in the case of fringe benefit regulations and commuting rules and 1978 in the case of independent contractor status. In the meantime, business people must make decisions having to do with these unresolved issues.

The logjam of court cases also pays tribute to problems of technical complexity. Timely judicial interpretation are a thing of the past.

Procedural Uncertainties

The Internal Revenue Service has without question an enviable record of tax administration. We point with pride to the country's high level of volunteer compliance for which the Internal Revenue Service deserves much of the credit. In recent years, however, the increase in complexities have made the system unmanageable. Taxpayers have reacted with revolt. They are fed up with a system they do not understand and with which they cannot cope. This revolt has resulted in a crippling increase in the amount so called "must work" for agents and auditors. Tax administration is adversely influenced by abusive tax shelters, tax protestors, and most importantly the underground economy.

Current concern in many quarters within the Internal Revenue Service is how to implement the "must work" programs. To illustrate, under Rev. Proc. 83-78 the Internal Revenue Service is notifying investors in abusive tax shelters of an impending audit should these investors claim tax benefits related to their investments. Managers within key districts are concerned that they do not have the necessary manpower to audit all of the investors who have been sent notices. In other words, the Internal Revenue Service has an effective weapon but no delivery system.

The mountain of technical provisions which bury all but a few Internal Revenue Service auditors and tax advisors is clearly equaled by the procedural promulgations articulating the "Do's and Don't's" of tax administration. The Internal Revenue Manual is a full 9 volumes and over 9000 pages. This manual is regularly modified to accommodate changes in the Code and changes in Internal Revenue Service program direction and policies. Revenue agents are inundated with a wide variety of memoranda which supplement the changes to the Internal Revenue Manual. It is quite simply not possible for Internal Revenue Service auditors to keep pace with these instructions. This results in an inconsistent application of the law, frustrating the efforts of auditor and tax advisor alike. I find in my practice an ever increasing number of auditors and agents who are not only unaware of what the Internal Revenue Manual provides but unable to research issues within it. When an Internal Revenue Service manager and/or the National Office issues a memorandum it will be ineffective unless, first, it is read by those to whom it is directed and secondly, it is interpreted the way it was intended by its author. Internal Revenue practices and policies, as published, are as a result of this confusion radically different than the practices and policies as practiced. Appendix "A" contains a much more detailed technical analysis of problems concerning tax administation with specific examples of problems encountered in my CPA practice.

Diseconomics Of Small Scale Business

There are distinct systematic tax disadvantages to being a small business person. First, bigger companies seem to be better able to cope with all types of financial uncertainties. Secondly, disputes with the Internal Reveuen Service of large amounts are more susceptible to settlement. Thirdly, small businesses often cannot afford to pay for professional guidance necessary to reduce the uncertainties to a manageable level. As a result, small business people are forced tp play the"tax lottery" and "take their chances"

Clearly uncertainties abound. In the words of an Ex-Internal Revenue Service, Group Supervisor now practicing as a Certified Public Accountant.

> "I cannot believe how screwed up the system is. When I was with the Service, we thought the problems were the exception. Now that I'm out I see that they are the rule. Other Ex-Internal Revenue Service agents and managers share may feeling."
>
> You never know exactly what they are going to do so it makes us look like idiots. I've been amazed since I 've been out of the Service how screwed up they are, and it is getting worse not better."

Corrective Action

It is my considered opinion that no amount of money, manpower, policies or procedures can stem the tide of growing confusion. The problem will only be solved through a reduction of the tax rates to take the profit out of cheating and simplification by substituting a broad based tax for the existing tax base. Appendix "B" contains a more detailed description of such an alternative broad based system. Exhibit "A" which follows depicts in general terms a suggested tax form format to accommodate such a system.

Conclusion

In conclusion, I would like to relate a humorous message given to me in 1978 by the then chairman of our University Accounting Department. Upon learning , I would be testifying before House Ways and Means Committee he said "Phil please tell them to reform the tax laws so the average CPA with a doctorate in accounting can understand it."

Hearings such as this are a very large step in the right direction.

Senator **Grassley**. Howard, you talked mostly about the corporation income tax, but would you apply what you said, where applicable, to the individual income tax as well?

Mr. **Phillips**. Clearly, Senator.

Senator **Grassley**. And also for the abolition of the individual income tax, as you suggested for the corporate tax, or not?

Mr. **Phillips**. Well, the conservative caucus is supporting a piece of legislation which has been introduced in the House of Representatives by Congressman Mark Siljander of Michigan, H.R. 5432, a 10-percent flat rate income tax. And we believe that the proposal which the Congressman has put forward is one which would raise adequate revenues for the appropriate functions of Government, while at the same time permitting people to fill out their tax forms—not in 10 days or 10 hours but in much closer to 10 minutes.

We think there is much too much complexity not simply with corporate taxation but with respect to the individual income tax as well.

Senator **Grassley**. One of your accusations against the corporate income tax was that it is easy to avoid responsibility as that tax is raised by the Congress. I mean, you really hide the tax increase.

Do you find that same accusation applicable maybe to like a consumption tax—let me not say "consumption tax," let me say "value-added tax," as an example, which is a broad-based tax that is applied through the economy.

Mr. **Phillips**. Senator, I have a strong bias against creating any new ways of raising taxes. Our experience has been that when new tax-raising devices are adopted they do not replace those already in force,they are merely added to them. Furthermore, I don't believe that the value-added tax is appropriate, in the sense that it would bear especially heavily on large families which use a disproportionate share of their income as compared to smaller families or single individuals in terms of consumption. I think it would be a tax that would militate heavily against lower income people, and it's a tax that simply, by opening up a new line of raising revenue, tempt those in public office to find new ways to spend the money.

If we look at the experience of the last several years, we observe that taxes have indeed been raised despite occasional talk about tax reductions. In fiscal year 1980, revenues from all sources to the Federal Government came to $517 billion. It is projected that for fiscal year 1985 those revenues will come to some $745 billion. And despite that increase of more than $200 billion annually in revenues to the Federal Government, we are still looking forward—not with pleasure—to some of the largest deficits in the history of our Republic. The reason for that is not that taxes are too low but that spending is too high.

I personally don't believe that the answer to our deficit is to raise taxes or to find new sources for collecting taxes; it's to hold down spending.

Senator **Grassley**. Senator Haskell, you spoke of what Democrats did to the Tax Code in the way of too many credits; you spoke about what Republicans had done in the way of ACRS. Is it implicit in your comment that the corporate tax code pre-1962, then, would take care of most of our problems? I think most of those credits have developed since the Tax Code of 1963 or 1964, right?

Senator **Haskell**. I think you would have to go back a little further; I think you would have to go back to 1954. I was referring to investment credit under Kennedy as the Democratic mistake and fast-depreciation under Eisenhower which led to ACRS, as the Republican mistake.

Probably if you went back——

Senator **Grassley**. All right. It was fast, enhanced depreciation, not just depreciation generally.

Senator **Haskell**. Oh, no—enhanced depreciation. So if you went back prior to 1954—this is a top-of-the-head comment—I think at that time income, that business people regard as income, was taxed.

I remember when the 1954 Code was passed. I had a small utility as a client, and the treasurer couldn't believe his eyes. He said, "My God, it's a tax-free loan from the Government" (he referred to accelerated depreciation) "Is it going to stay?"

I said, "I don't know whether it is going to stay or not, but you might as well take advantage of it." So that is how it was regarded at that time, and that was really the kick-off in many ways of what I consider the disintegration of the simple system.

Senator **Grassley**. All right. But in no way are you arguing against the corporation income tax, per se?

Senator **Haskell**. No; I'm not. However, I feel that we should make the income tax broad-based and tax corporations and individuals. But we should recognize that the corporate tax is a disincentive—if that is the proper word—to invest in corporate form.

For example, it encourages people to put their money in real estate or drilling deals, or something like that, rather than listed securities.

Now, there are solutions to the problem, as I'm sure the chairman is very well aware. One solution is follow the Europeans. Give a credit for dividends paid—up to a specified limit—if half the income is declared out in dividends, then only half the corporate income is taxed because the other half is going to be taxed to the individual.

Now, there are other solutions. But I do want to state that I believe that the people who talk about the double tax on corporations have a very worthwhile viewpoint, and I think the problem should be addressed.

Senator **Grassley**. I would like to have each of you, if you could just quickly, tell me, as an alternative to the present tax system what you would favor, whether it would be a gross income tax, a national sales tax, consumption tax, value-added tax, flat-rate income tax, or a combination of those, or none of those, so we could get you on record, if in fact you are for a change.

I guess you could still be for a simplified corporate tax system and a simplified income tax system, which would be a modification of what we have now and which would not be all that new.

Mr. **Alexander**. Mr. Chairman, I would like to comment first, if I can, about treating corporations as partnerships. That's an interesting theory; it has been around for about 40 years or so and probably won't be adopted.

Let's take IBM as our example, a company that pays out a relatively small percentage of its earnings as dividends, not as small as it used to but nevertheless small. I think a housewife in Des Moines would be quite surprised if she owned 100 shares of IBM to find that she was taxed on her tax of IBM's profits that year, whether or not it was distributed. Now, that is going to put tremendous pressure on the IBM's of this country, the companies that pay out a relatively small percentage of their taxable income in dividends, to pay out more. And I am not all that sure that is a good idea. Nor am I sure that a flat-rate tax at a very low rate is a good idea, unless somehow that is going to be tied to reductions in spending. And those who want to hold the tax system hostage through their hoped-for but never-achieved spending reductions I think are marching in the wrong direction.

I would like to see some reductions in spending, too, but I don't think you hold the tax system hostage or do it for that reason. I support a value-added tax. I think we put just too much on our income tax, and I don't think we can produce a broad-based, reasonable, sensible, and understandable income tax in this country unless we have another tax that supplements the income tax in a fairly major way.

The percentage of aggregate Federal revenues as a part of GNP has been dropping, not rising; but the percentage of spending has held up. So we've got a massive deficit. I am afraid you are going to keep that until you find some way of coping with it.

Our trading rivals use a value-added tax fairly well in competition with us, and let's not forget that Japan, by the way, collects more in the way of corporate taxes, relatively speaking, than we do. So they have done pretty well competing with us, despite the excessive burden of the corporate income tax.

Senator **Grassley**. Is your value-added tax suggestion in addition to or a replacement for the personal income tax?

Mr. **Alexander**. A value-added tax would be a supplement to a broad-based, lower rates but not flat rate, personal income tax and a broader based, lower-rate corporate income tax. The aggregate revenues produced by those two is simply not going to be sufficient for our country to operate the way that the public or the Congress expects.

Given that situation, and given I think the possibility of thinking that those taxes are going to produce enough revenue to cut back on our massive deficits, I would hope that a value-added tax at a lower rate, broad based, would be a sensible supplement to the reduced revenues which we can reasonably expect from a broader based lower rate, personal income-tax and a lower rate broader based corporate tax, with perhaps an act provision like that to which Senator Haskell referred, a passthrough, a credit at the individual level for part of the taxes paid by the corporation.

Senator **Grassley**. Senator Haskell.

Senator **Haskell**. Mr. Chairman, I would favor the broad based—by that, we mean getting rid of the barriers—personal income tax, and a broad based business tax—whether it be on partnerships or corporations—with progressive rates but obviously lower than at the present time.

I personally, as I said before, feel that the double taxation of corporations can be taken care of by following some of the Europeans on credits for the payouts in the form of dividends.

In summary form, that would be my recommendation, Mr. Chairman.

Senator **Grassley**. Howie.

Mr. **Phillips**. Senator, there are really only four ways, as you know, that we can deal with the problem of the deficit: We can either raise taxes, we can inflate the currency, we can borrow money—or we can cut spending. And the only good solution, in my view, is to cut spending.

Earlier this year you were a leader in the Senate in favor of a budget freeze. While I might have had some disagreements with aspects of that particular freeze, I think the concept of a spending freeze is a very important one to seriously consider and to move forward with.

It is important for us to recognize that none of these deficits which we are encountering today would exist if we had frozen Federal spending in 1980. In fiscal year 1980, total Federal outlays were $576.7 billion. For this fiscal year 1985 we are talking about outlays of $925.5 billion. So, clearly, the deficit problem can be addressed if we solve the spending problem.

I believe that in order to have a tax system which is fair, we need to eliminate the corporate income tax, and I think we need to move forward to a 10-percent flat rate income tax.

I also believe that we need to move toward the kind of constitutional money standard, honest money standard, gold standard, which will prevent the arbitrary and unpredictable escalation of interest rates which have contributed so mightily, especially in recent years, to the size of our Federal deficit.

Senator **Grassley**. Thank you.

Mr. Storrer, you said that you favor the value-added tax. Was that in addition to personal and corporate income taxes or in place of it?

Mr. **Storrer**. No, Mr. Chairman. I would favor strongly a flat-rate consumption-based value-added tax, implemented in a way which would eliminate the need for nonbusinesses, individuals, to file a tax return. In other words, only businesses would file. The way you would do that, very simply is that you would not allow business to deduct factor payments to households; they would in essence be paying the tax, remitting it—not bearing the burden, but remitting the tax—on behalf of the households to whom those payments were made for wages, interest, and rents.

I think I would have a flat rate, because the proportional rate system appears to me to be the only system that we could say is equitable in treating the all members of the public at large.

If you argue in favor of progressivity, it appears to me that the only way you can do that is on the basis that it makes us feel better, not economic grounds. And if collectively we think it makes us feel better to have a progressive rate, that those who make more ought to pay not only more but progressively more, then, the next question is, how progressive do you want to make it? And you are going to have 150 million different responses to that question.

The second reason is complexity. When you have a progressivity in your tax system, then you have filing status requirements, and you instantly sacrifice simplicity for the sake of equity.

Senator GRASSLEY. I have to stop asking questions, but let me suggest to you that some of the things that this committee really ought to be interested in—and I have questions for them and should probably submit some of them in writing—deal with how the deliberations of a board of directors or a CEO on spending money and capital investment, or in some other way, are affected by the Tax Code?

For that plant manager to keep his inventory high or to keep it low, to what extent does the Tax Code enter into that decisionmaking process, and whether or not that affects productivity or not?

And I suppose there are several other examples like that. That is eventually what this committee has to respond to, the extent to which the Tax Code inhibits productivity or does not.

We have been dealing with this, and correctly so, in a broad way. But I think we need answers to those questions. I am going to decide with my staff later on, but we may submit those to some or all of you in writing. So thank you very much. I am sorry that I have to move on, because we have two other very good panels to hear from.

All right, now. I have another panel that I would like to have all come at one time.

We have John Meagher, chairman, Basic Industries Coalition; Donald W. McCambridge, division comptroller for taxes, Bethlehem Steel Corp., on behalf of the American Iron and Steel Institute; Dr. Robert C. Holland, president of the Committee for Economic Development; and Lana R. Batts, managing director of research and policy analysis division of the American Trucking Association; Frederic Howard, chairman of the tax task force, Coalition of Service Industries, Washington, DC; and Wilbur D. Holleman, vice president, tax, the Fluor Corp., on behalf of the National Constructors Association, Washington, DC.

Now, there is one missing. I wasn't looking up as you were seated, and I don't recognize all the faces. Who isn't here?

Frederic Howard is not here. All right.

What we will do then, we will go in the way I introduced you, if that is all right. Would you please start out?

STATEMENT OF JOHN MEAGHER, CHAIRMAN, BASIC INDUSTRIES COALITION, INC., WASHINGTON, DC

Mr. MEAGHER. Thank you, Mr. Chairman.

My name is John Meagher, and I am a vice president of the LTV Corp. in Dallas, TX, and chairman of the Basic Industry Coalition, otherwise known as BIC, which is an association of over 25 companies and trade associations involved in 8 basic industries, established in 1983, to provide leadership in governmental policies affecting the continued health and effectiveness of basic industries in America.

Since the particular focus of the coalition has been to promote capital formation and tax policy alternatives, which will provide the basis for long-term economic growth and vitality, we are particularly pleased that you scheduled these hearings and grateful that we have been given the opportunity to present our views.

Before I detail those views, however, I would like to mention some historical facts about the reason that the Basic Industry Coalition was formed:

It was established by companies in the United States who feel that they have been discriminated against in our tax laws vis-a-vis incentives to capital. It is our charter to make attempts to end that discrimination in order to make our basic industries world-class competitive and more productive.

Very simply, the discrimination is that many companies in this country don't get the tax benefits—particularly the investment tax credit and depreciation—currently, when they purchase equipment unless you have tax liability on a current basis. The reasons why they may not have tax liability are many, but in most instances it is because they have had significant losses and they have tremendous net operating loss carryovers that will void either currently or some time in the future their tax liability. When they go out and buy plant and/or equipment they are paying a significant premium for that capital. This fact puts these companies at a distinctive competitive disadvantage vis-a-vis their competitors, both foreign and domestic.

We feel that it is this kind of discrimination in the tax law which goes right to the heart of our ability to compete and be productive.

Our foreign competitors don't have these kinds of discriminatory practices; in fact, in most instances they provide lower cost financing, trade protection, and in many instances generous subsidies to target industries which have impacts on world markets.

We favor policies which will even up this uneven situation, both domestically and as far as our international competition is concerned.

Recent actions by the Congress, unfortunately, have moved in the opposite direction. In 1981 the Reagan administration proposed and Congress passed the most pro-capital tax bill in history. It contained increases in the accelerated depreciation area, research and development credits for high tech companies, and some other items such as safe harbor leasing which were an attempt to even the playing field.

One year later in TEFRA the Congress took action to reverse these incentives. It repealed safe harbor leasing, repealed several of the post-1984 changes in the accelerated depreciation rates, reduced the basis for capital items for ACRS and the investment credit. And the bill that is currently in conference, that you are reading about now, will make further reductions in ACRS, repeal finance leasing, certain energy tax credits, and obviously limit the use of industrial bonds under which a lot of basic industries do a great deal of environmental financing.

What does this mean in dollars? Consider safe harbor leasing, which is perhaps the most efficient investment incentive ever enacted for capital-short basic industries.

The 3 years it was in existence it made possible over $60 billion in new plant and equipment at a revenue cost of $10 billion. Thus, for every dollar spent of Government money, American industry spent $5 in new investments in plant and equipment.

This return on investment was generated in the worst recession in 30 years, with interest rates at historically high levels and with many companies in loss positions.

While we understand the need for revenue and the severe problem facing all with regard to the deficit, we also think Congress and the administration should come to grips with the fundamental problem we have if we are going to have a productive society.

In that regard, the Basic Industry Coalition has proposed a bill called The Work Opportunities and Renewed Competition Act of 1983, which can be updated for 1984. It is introduced in the Senate as S. 1593, and in the House as H.R. 3434.

Very simply, "WORC" allows companies and individuals with already earned but unused investment credits prior to the year of its enactment to borrow from the Federal Treasury 85 percent of their value after the taxpayers have invested their own money in new plant and equipment in the businesses in which they are already engaged. Assuming a 1984 enactment date, the reinvestment of these funds would have to be completed by 1986.

The taxpayer involved under the bill would be required to pay back to the Treasury not just the 85 percent, but an additional 15 percent as well beginning in 1987. This would be paid either in the form of higher taxes or at the rate of 20 percent per year until repaid; but in any event no later than 1991 it would be repaid.

Why would taxpayers elect such a device? Simply, because they must make the investments now in order to be competitive later. They recognize the present value of money and have little choice but to utilize this provision if they are to expand their capital base.

WORC will raise some revenue for Congress if it will let us borrow the money so that we can pay it back later. In the long term, we think that the Congress must address policies dealing with the discrimination that we have mentioned here today and which will allow us to utilize the tax benefits that our investments supposedly give us.

In this connection, Mr. Chairman, your hearings are important and a critical first step in dealing with the problem we are concerned with and which we have tried to highlight today.

Thank you very much. I would be glad to answer any questions.

Senator GRASSLEY. I will wait with the questions until we are done with the panel.

Donald McCambridge.

[Mr. Meagher's prepared statement follows:]

Testimony of John K. Meagher

representing the Basic Industries Coalition, Inc. (BIC)

Mr. Chairman, my name is John K. Meagher, and I am the Vice President-Government Relations of The LTV Corporation headquartered in Dallas, Texas. LTV is a diversified operating company involved in steel, energy products, and aerospace/defense. I am here today representing the Basic Industries Coalition, Inc. (BIC), an association of over 25 companies and trade associations involved in eight basic American industries, which was established in 1983 to provide leadership in developing governmental policy positions to insure the continued health and competitiveness of our basic industries. Since the particular focus of BIC has been to promote capital formation and tax policy alternatives which will provide the basis for long-term economic growth and vitality, we are particularly pleased that you have scheduled these hearings and grateful that we have been given the opportunity to present our views. Frankly, Mr. Chairman, this is the first time any Congressional tax-writing committee has held hearings on the capital and tax problems facing basic industries. These sessions are as timely as they are important.

Before I detail our views on how the tax system affects basic industries, let me provide some historical information about BIC and why it was formed.

BIC was formed by companies representing U. S. basic industries who have been discriminated against by our tax laws vis-a-vis tax incentives to capital. Its charter is to make attempts to end that discrimination in order to make our basic industries world class competitive.

With the enactment of the Investment Tax Credit in 1962, our tax system has provided most companies with major incentives to modernize, to buy new plant and equipment. Theoretically, when LTV puts in a new continuous caster, it is entitled to a 10% tax credit by virtue of the purchase of that equipment.

Unfortunately, the practicalities don't always follow the theory. That is true because the 10% credit is available currently only if the taxpayer has current tax liability against which to use the credit. If the company happens to be in an industry like steel which has had serious problems for several years, it may not pay income taxes currently and thus will be unable to use the credit. Although the law provides for carrybacks of 3 years and a 15-year carryforward, the value of the credit diminishes as a function of the time value of money. As a result, in real terms, it is questionable whether the tax benefit is really related to the investment and, in fact, may be detrimental to the extent that it is available to certain competitors. Simply, our current tax law rewards the rich companies with the ITC and depreciation allowances at the expense of the poorer companies. This is the discrimination I spoke about and why BIC was formed.

It is our contention that this discrimination - which results in diminished capital investment and its attendant lower productivity - is at the heart of the decline of our industrial strength and the rise in foreign competition. Our foreign competitors not only provide the kinds of incentives I am discussing, but usually far more including low cost financing, trade protection, and in many instances, generous subsidies to target industries to have an impact on world markets.

The predicament of the American industrial sector has been described in a recent avalanche of books, articles, TV stories, editorials, etc. The message has been the same - we must get our policy act together if we are to survive as a viable world leader and economic entity. While the experts may and do differ on the solutions, they all acknowledge certain facts:

- Our productivity, until recently, has been declining at an alarming rate. During the 1970's our productivity grew by 20% while Japan's jumped 145%, Germany's 75%, and France's 77%.
- In the last ten years manufacturing investment in the United States has fallen behind the countries of our competitors. Japan has consistently outpaced us by 4 to 5 points. Even the UK is ahead by a similar margin.
- Our employment levels generally are not good. In basic industries, they are poor. While since 1971 total employment in the U. S. has increased by 2.1%, in basic industries, it has dropped by .3% and by 4.6% in steel.
- The cost of capital in America is double or quadruple its cost in foreign countries. In Japan, the cost of capital is 4% - 8% versus 16% - 22% in the United States.

As we in the steel business are well aware, we are competing in a world economy against companies and governments which must market their products in the United States in order to survive. Our free trade policy and our discriminatory tax policies offer a double incentive to foreign competition. On the trade side, they have generally free access to our markets, and while many of them enjoy tax and other capital incentives, many American companies do not. We have, in effect, placed ourselves in a double disadvantage and unless these are corrected, we won't be able to compete for very long.

We favor policies which will even-up this uneven situation both domestically and as far as our international competitive situation is concerned.

Recent actions by the Congress unfortunately have gone in the opposite direction. In 1981, the Reagan Administration proposed and the Congress enacted the most pro-capital tax bill in history. It contained ACRS, an increase in the R&D tax credit to help high-tech companies and a small item called Safe Harbor Leasing. It recognized the historical disparity between the U.S. and its trading partners on depreciation levels and access to capital incentives and essentially corrected it.

One year later, the Tax Equity and Fiscal Responsibility Act of 1982 reduced or eliminated these and other incentives for capital by:

1. Repealing Safe Harbor Leasing
2. Repealing the post 1984 changes in ACRS rates
3. Reducing the basis of capital items for ACRS and the Investment Tax Credit

If that wasn't enough in the current tax bill Congress will doubtless make further cutbacks. These include:

1. Further reductions in ACRS
2. Repealing finance leasing and energy tax credits
3. Limiting the use of industrial bond financing under which we do much of our environmental improvements.

What does this mean in dollars? Consider Safe Harbor Leasing. Perhaps the most efficient tax incentive ever enacted for capital-short basic industries, in the three years it was in existence, it made possible over $~~[illegible]~~ 59 billion of new plant and equipment at a revenue cost of nearly $10 billion. Thus, for every $1 the government spent, American industry spent $5 in new investment. This incredible return on investment was generated during the worst recession in 30 years and with interest rates at historically high levels. We did our caster under a Safe Harbor Lease, and we'd do more but the Congress thought it a give away and decided to junk it.

Let me put this provision in perspective. The American steel industry needs $6 billion in new investment to become modern and competitive. If the government would put up $1 billion over a three-year period, the industry could put thousands of workers back into the economy. $1 invested to get $5 in return.

While we understand the need for revenue and the severe problem facing all relative to the deficit, we also think Congress and the Administration must come to grips with the fundamental discrimination in the tax law I've previously discussed.

We have tried to recognize both problems in fashioning a proposal called The Work Opportunities and Renewed Competition Act of 1983 (WORC). This legislation was introduced in the Senate as S 1593 primarily by Senators Durenberger and Riegle and in the House as HR 3434 by Reps. Conable and Jones.

WORC allows companies and individuals with already earned but unused ITC's prior to 1983 to borrow from the Federal Treasury 85% of their value after the taxpayers have invested their own money in new plant and equipment in the businesses in which they are already engaged. Assuming an October 1, 1984, enactment date, the reinvestment of these funds would have to be completed by 1986. The taxpayers involved, under the bill, would be required to pay back to the treasury not just the 85%, but an additional 15% as well beginning in 1987. This would be repaid either in the form of higher taxes or at the rate of 20% per year until repaid, but, in any event, no later than 1991.

Our estimate of the fiscal impact of the legislation is that by 1991, there would be a net positive revenue result of $800 million with about $1 billion coming in between FY 1986-1988.

This results from the mandatory payback provision requiring companies electing to use the reinvestment credit provision to pay back 15% more than they borrowed.

Why would taxpayers elect such a device? Simply, they must make investments now in order to be competitive later. They recognize the present value of money and have little choice but to utilize this provision if they are to expand their capital base.

Thus, WORC deals with Congress's problem and that of basic industries.

Obviously, this is a one-time, short-term attempt to deal, in part, with the discrimination in the law today. It doesn't solve the problem entirely, but it helps.

In the long term, we believe Congress must address the problem in the current law of the timing between the utilization of tax beneifts and the investment to which they are tied.

Investment incentives - such as the Investment Tax Credit (ITC) and Accelerated Depreciation (ACRS) are intended to front-load the cash flow which results from new investment. That front-loading occurs where they - particularly the ITC - can be utilized currently.

One of the most basic questions is whether the government gets the best bang for the buck it puts out? Under current law, the answer is probably -- no!

What should be done about this? One answer is to junk these incentives. In fact, this has occurred for many industries in this country which continually spend more in capital than they make and get little or no benefit from this incentive. The other answer is to change the timing to insure that the incentive plays a real role in investment.

Obviously, the latter course makes more sense. In our view, Congress should address this problem next year when it reviews the tax system. We think it is fair and important that the playing field be level vis-a-vis domestic investment, and we believe it ought to be fair vis-a-vis the world market. In this latter regard, we are presently working on proposals which will be presented to you later in the year to deal with making the international playing field level.

STATEMENT OF DONALD W. McCAMBRIDGE, MANAGER, TAX LEGISLATIVE ANALYSIS, BETHLEHEM STEEL CORP., BETHLEHEM, PA, ON BEHALF OF THE AMERICAN IRON AND STEEL INSTITUTE, WASHINGTON, DC

Mr. McCAMBRIDGE. Thank you, Mr. Chairman.

Since I am from the Bethlehem Steel Corp. and John is from LTV, I am also active in the Basic Industries Coalition as well as chairman of the American Iron and Steel Institute's tax committee. So actually, some of my remarks may restate what John has said but possibly in a little different way.

The steel industry is energy, labor, and capital intensive, and therefore likely to be affected by tax policies in those areas.

The Federal income tax policies associated with the taxation of capital have had a particular impact on the steel industry, and my summary will concentrate on those areas—specifically, the fact that the current policies result in the inability of the industry to realize on a current basis the capital investment incentives intended by the Congress.

The two principal capital investment incentives are the investment tax credit and accelerated capital recovery.

Generally, through the late 1970's the steel industry had a sufficient level of income to realize the current benefits of the capital-recovery deduction and to permit the current use of most if not all of the investment tax credits.

A combination of events in the early 1980's changed all that. First, the level of capital spending relative to the level of income eventually resulted in the situation where there was a limitation on the use of current investment tax credits even after a carryback.

Second, the substantial losses that occurred in the early 1980's were carried back, and offset against the profits of the late 1970's, resulting in a further loss of the availability of tax credits.

Furthermore, the losses resulted in the inability of most companies to benefit from the intended incentive feature of the ACRS system. The result is that now, and for the foreseeable future, the steel industry will not be able to reduce the cost of its capital investments to the same extent available to more profitable companies.

Congress recognized this inequity, as John said, and attempted to deal responsibly with the problem when safe harbor leasing was enacted in 1981. The provision, as he said, was repealed shortly thereafter, but the equity of safe harbor leasing, the intent to level the playing field, has never really been seriously challenged.

To make matters worse, the financel lease provisions which were intended as a partial substitute for safe harbor leasing will be subject to a 4-year suspension, since the deferred provision is the same in both bills before the conference. And to make matters complete, the nature of steel capital investments is such that a high percentage is for capital rehabilitation of existing facilities and, in general, almost none of the capital investment qualifies for traditional guideline leasing.

The net result is that current tax policy does not permit the steel industry to participate in the capital incentives associated with the ownership of the assets, and it essentially denies it the opportunity afforded to other companies to at least share in the benefit of those incentives with more profitable companies.

The steel industry has a cumulative balance at the end of 1983 of $1.2 billion of unused investment tax credits which have been earned but cannot be used only because they exceed the limit allowable, and over $5 billion in excess net operating losses, virtually all of which occurred in 1982 and 1983.

If the current 85-percent limitation on the use of investment tax credits had been in effect since 1962, a substantial amount of the unused credit base would have been used to offset taxes in prior years.

The income tax laws have always provided that losses from one accounting period could be offset against profits from another accounting period in order to recognize the cyclical nature of some businesses. In 1981 as part of ERTA, the lowest period for both investment tax credit and investment credit was increased to 15 years in anticipation of tax losses which might result from the ACRS system.

In summary, what we need is a policy change which would permit less profitable companies like the steel companies to obtain equal access to the prior, current, and future tax benefits associated with capital asset incentives. This could be done in a variety of ways which would only change the timing of the recognition of the tax benefits.

John has already gone into at some length the program which would allow cashing in the existing investment tax credit balance for a cash payment. Another way would be to permit an extended net operating loss and investment tax credit carryback as well as a carryforward. And a third would be to restore some degree of freer transferability of current tax benefits through a safe harbor leasing mechanism, or something of that sort.

As I say, this would only change the timing of the recognition of the tax benefits, but the access to the cash for the steel industry is critical at this time.

Thank you, Mr. Chairman.

[Mr. McCambridge's prepared statement follows:]

Statement of

Donald W. McCambridge

I am Donald W. Mc Cambridge, Manager Tax Legislative Analysis for Bethlehem Steel Corporation and Chairman of the Committe on Tax for the American Iron and Steel Institute. I am speaking here today on behalf of the American Iron and Steel Institute, the principal trade association of the steel industry, whose 57 domestic member companies account for approximately 87 percent of the raw steel produced in the United States.

'The purpose of these hearings in part is to examine the impact of the Federal income tax system on basic industry. Steel is about as basic as they come. Unfortunately, for many years the steel industry has not been able to sustain a satisfactory level of profitability and, therefore, it follows that the aggregate income tax payments and also the "effective tax rate" of the industry have not been among the highest of the various industry groups.

The steel industry is labor intensive, energy intensive, and capital intensive and therefore is more likely to be affected by tax policies in those areas.

There are several areas in which Federal income tax policies associated with the taxation of capital have had a particular impact on the steel industry. The more important can be summarized as follows.

1. The inability of the industry to realize annually on a current basis the capital investment incentives intended by Congress.

2. The inability to realize currently the ultimate tax benefit of excess net operating losses and investment tax credits.

3. The perverse effects on the industry of attempts by Congress to deal with low corporate income tax payments through the minimum tax.

These are developed more fully below.

1. Capital Investment Incentives

The two principal capital investment incentives enacted by Congress are the investment tax credit and capital cost recovery. The investment tax credit has been in effect except for two periods of suspension since 1962. Some form of accelerated depreciation has been in effect since 1954, culminating with the ACRS system enacted in 1981. For most of that time, generally through the late 1970s, the steel industry had a sufficient level of income to realize the current benefits of the capital recovery deduction and permit current use of most if not all of the investment tax credits. A combination of events in the early 1980s has changed that dramatically.

First, the sustained increase in capital spending with higher depreciation deductions eventually resulted in a limitation on the use of investment tax credits on a current basis. Second, the situation was exacerbated when substantial losses incurred in the earlier years of the 1980s were carried back to reduce or eliminate the income of the late 1970s resulting in a further loss of the availability of tax credits. Furthermore, the losses resulted in the inability of most companies to benefit from the intended incentive feature of the ACRS System.

The result is that now and for the foreseeable future the steel industry will not be able to reduce the cost of its capital investments to the same extent available to more profitable companies. This lack of equality is inherently wrong as a matter of tax policy. It deprives less profitable companies of a source of capital when it is needed the most, thereby discouraging capital spending and contributing to the liquidation of the industry. Congress recognized this inequity and attempted to deal responsibly with the problem when safe harbor leasing was enacted in 1981. Unfortunately, this provision was repealed shortly thereafter for political, rather than economic reasons. The equity of the economic benefit provided to the low profit company by permitting it to realize some cash benefit from its investment has never been seriously challenged. To make matters worse, the finance lease provisions, which at best would have been a poor substitute for the flexibility afforded by safe harbor leasing, would be deferred for four years under similar provisions of the tax bill currently before the conference committee. We have to assume that the deferral may eventually become a repeal. To make matters complete, the nature of steel capital investments is such that a high percentage is for capital rehabilitation of existing facilities very little of which qualifies for traditional guideline leasing. The net result is that current tax policy does not permit the steel industry to participate in the capital incentives associated with the ownership of assets and essentially denies it the opportunity afforded to other companies to at least share in the benefit of those incentives with more profitable lessor companies.

2. Accumulated Unused Net Operating Losses and Investment Tax Credits

The combination of events of the last few years has resulted in the industry having a cumulative balance at the end of 1983 of $1.2 billion of investment tax credits which have been earned but could not be used because they exceeded the allowable limits. In addition, over $5 billion of excess net operating losses have been accumulated. Both of these balances may be carried forward for 15 years from the date the tax credit was earned or the loss incurred to reduce future tax liabilities. Virtually all of the net operating loss originated in 1982 and 1983 and about half of the investment tax credit carryover is a direct result of those losses. In this case, it is not the absence of a reasonable tax policy which impacts adversely on the industry but rather a restriction in the application of this valid tax policy due to the imposition of arbitrary limitations. By way of illustration, the original limitation on the use of investment tax credits was 25% of the liability. This was raised to 50% in 1967 and beginning in 1979 the limit was raised 10% each year until 1982 when the current 85% limit was established. If the current 85% limitation had been in effect for all years a substantial amount of the unused balance would have been used to reduce taxes paid in prior years.

There has always been a recognition in the income tax laws that losses from one accounting period should be allowed to reduce income from another period in order to recognize the cyclical nature of some businesses. For many years the total period was eleven years -- the current year, three back and seven forward. In 1981 the carryover period was increased to 15 years in anticipation of tax losses which might be created by virtue of the excess capital cost recovery allowed by the ACRS system. The current tax policy therefore is to deal with the rationalization of income and losses over a 19-year period. Many basic industries, especially steel, could gain much needed investment capital from a change which would permit an extended carryback period to cover taxes already paid, in lieu of the extended carryover period.

3. Minimum Tax

The perverse effect of the minimum tax can be illustrated by the following example. Percentage Depletion is not an elective deduction - it is mandatory. However, in recent years this "deduction" has actually increased the tax burden of many companies. The reason is the interrelationship of the minimun tax with investment tax credits which have been allowed to offset up to 85% of a company's tax liability. Mathematically, a company with $1,000 of taxable income could owe only $69 of a tax after the maximum reduction of tax by applying investment tax credits. ($1,000 X 46% = $460 - (85% X 460) = $69. Now if that same company has $200 of percentage depletion, the taxable income would be reduced to $800, and the net tax would be reduced to $55 - a net tax reduction of $14. However, the amount of the percentage depletion - $200 - is considered to be a tax preference item. The excess of this preference amount over the net tax, in this case $145, is subject to a minimum tax of 15%, or about $22. The net result of having to claim an additional "deduction" from taxable income is to increase the net tax by about 8% of the deduction. We would obviously be better off without the so-called "preferential" item.

This condition has existed for most steel companies since 1980 and will continue to exist indefinitely into the future.

Considering that the actual percentage depletion is in the hundreds of millions of dollars, a large segment of the steel and mining industry is being severely penalized for a "preference" it does not enjoy. In the case of the steel industry, the minimum tax is essentially a tax on capital because it is the investment tax credit which reduces the tax liability and gives rise to the minimum tax. It makes absolutely no sense that the industry should have to pay an artificial minimum income tax while earned credits go unused because they can only be applied against regular income taxes.

Comprehensive Solution

The steel industry has estimated that during the period 1984-89 all available sources of cash will fall short of the requirement for capital spending by $1.1-$1.9 billion annually depending on the level of imports. Changes in tax policy will not completely eliminate this shortfall but would go a long way toward resolving the problem. There is one essential policy change which would be of great assistance over the next five years during which the industry has such a critical need for cash with which to finance modernization projects. That policy change would permit steel companies to obtain equal access to the prior, current, and future tax benefits associated with capital asset incentives. This could be done in a variety of ways including the following:

1. Permit an extended net operating loss carryback instead of an extended carryover.

2. Allow accumulated unused investment tax credit carryovers to be surrendered in exchange for an immediate payment, with the proceeds to be reinvested in steel assets.

3. Permit an extended carryback of unused investment tax credits.

4. Restore freer transferability of current tax benefits to other taxpayers which have a current tax liability. This could be accomplished through the restoration of something like safe harbor leasing, or a capital recovery system which produces a similar cash result to the taxpayer, while avoiding third party involvements.

5. Permit accumulated investment tax credits and the tax effect of net operating losses to be cancelled in exchange for government securities to mature in 7 to 15 years.

6. Repeal the minimum tax on corporations.

These changes would involve essentially only the timing of the recognition of tax benefits and do not involve any net revenue loss to the Treasury over time. The access to the cash at this time, however, is critical to the continued viability of the industry. In addition we believe these changes would remove pressures for tax motivated acquisitions and promote equality in the cost of capital for taxpayers making similar investments, regardless of the current level of income.

Senator GRASSLEY. Before we go on to Dr. Holland, let me lay on the table a question that you can be thinking about, because I don't want to stop the testimony. But just so I don't forget it:

Basically, as I listened to your two testimonies, you argue that we have made some changes that have been beneficial to increased productivity; you are arguing that they have been modified too early and that they ought to be changed to continue that trend of encouraging investment and changes which would bring about productivity. I would like to have your analysis on whether departure from the existing Tax Code to a dramatic change in the corporate or even the individual tax might not accomplish the same thing, or whether or not you see in the future, if we are really going to increase productivity and the Tax Code is going to encourage that, that we do it within the existing framework.

Dr. Holland.

STATEMENT OF DR. ROBERT C. HOLLAND, PRESIDENT, COMMITTEE FOR ECONOMIC DEVELOPMENT, WASHINGTON, DC

Dr. HOLLAND. Thank you, Mr. Chairman.

I am president of CED, a nonprofit, nonpartisan economic policy research organization comprised of about 200 of the Nation's business and academic leaders. We appreciate being invited to discuss our view of the relation of tax policy to productivity.

In a nutshell, CED believes that the United States has a serious problem of flagging productivity performance. Our productivity improvement since the trough of the 1981-82 recession has been heartening, but we think we are still a long way from being out of the woods.

This recent cyclical upswing in our productivity growth should not distract us from adopting the kinds of public and private policies we need to sustain productivity growth at a much higher level than in the past. And we believe tax policies are an important part of what needs to be changed to achieve that productivity improvement.

I put before you a full text of my statement and a copy of a study on productivity that CED released last year. A good deal of what I am going to say rests on that.

In that study we concluded that the United States faces not one but two serious productivity problems. The first one is the slowdown in the rate of its own productivity growth in the United States—slowing down that you can see in the evidence back even as far as 1966 and 1967. It became progressively worse, and the decade of the 1970's was very disappointing.

Even through the beginning of this decade the data were disappointing, until we got what amounts to a conventional cyclical upturn in productivity. That's no lasting solution.

The second problem we face is that U.S. productivity growth has remained significantly worse than that of our major international competitors. This evidence is capsulized in the chart that is on page 2 of that executive summary I attached to my testimony.

It takes many years for evidence on this complex a subject to accumulate to convincing proportions, but these figures convinced us that unless these trends in productivity were reversed, and reversed significantly, the United States was condemning itself eventually to becoming a second-rate economic power.

Why were we doing so poorly? This study as well as several others convinced us that under-investment in productive plant and equipment has been a major source of our productivity problems. It's not the only cause, but a major cause.

As we see it, the primary responsibility for turning that productivity performance around rests with the private sector: with management and with labor. But Government can be of significant help here, and particularly in the area touched on in this hearing, by reducing the investment-discouraging effects of Government regulations and of Government taxes.

In the past, Government tax provisions have discouraged really both sides of the investment equation—they have borne down heavily on private saving, and they have also been discouraging to expenditures on plant and equipment.

I hasten to add that you have recently taken some good steps in directions that can help remedy this burden. CED has applauded the introduction and the liberalization of tax deferment on interest earned through IRA's. We favor continued efforts to expand that kind of saving-encouraging change in the tax law. On the investment side, the adoption of ACRS was in our view a major step forward. We see it as having reduced the cost of capital across all industries, and this should contribute to long-range improvement in the rate of productivity in the United States. Indeed, we are already witnessing an encouraging step-up in the rate of capital investment in this country. However, ERTA worsened the already wide variance in effective tax rates among industries, and you have heard a few relevant comments here across the table this morning.

Some of that variance was reduced in TEFRA, but let me emphasize that we as an organization continue to recommend a tax policy that is essentially neutral among industries. We believe neutrality is a very worthwhile goal to strive for.

One way to achieve this is to permit the expensing of capital outlays. Adoption of expensing would permit eliminating a number of special business tax provisions, such as investment tax credits, and it would also allow a general reduction in the corporate tax rate.

This expensing idea, we must admit, poses the same kind of conflicting considerations that tax-writing committees of the Congress have so often had to deal with. It is a tax change that would encourage what we regard as a very important improvement—namely, increasing the share of the Nation's total output devoted to saving and investment, as distinct from consumption.

But expensing would probably also involve a significant loss in Federal revenue, at least in the short run, and thus deepen an already huge Federal deficit that badly needs to be reined in.

For this and other reasons, therefore, we are strong supporters of a determined Federal effort to achieve meaningful basic tax reform in the coming years. To do our part to help on that tax policy debate, we have commissioned a careful study to evaluate the relative advantages and disadvantages of several alternative types of reform to the Federal tax structure. We expect to have it available around year end, and we will be glad to share it with you. We hope it can help not only ourselves but other concerned citizens and public policymakers who are interested in achieving a tax structure that can better serve our combination of national goals.

Thank you.

Senator GRASSLEY. Ms. Batts?

[Dr. Holland's prepared statement follows:]

Statement by

Robert C. Holland, President

Committee for Economic Development

Mr. Chairman, my name is Robert C. Holland. I am President of the Committee for Economic Development, a nonprofit, nonpartisan economic policy research organization comprised of over 200 of the nation's business and academic leaders. It is the intense personal involvement of such corporate and education leaders in the development of CED's policy recommendations that distinguishes CED from other business organizations.

I very much appreciate being invited to discuss CED's views on the relation of tax policy to productivity. It is a subject I believe we are well prepared to address. In a nutshell, we believe we have had a serious problem of flagging productivity performance. While the productivity improvement since the trough of the recession is heartening, we are by no means out of the woods. The recent cyclical upswing in productivity growth should not distract us from adopting the kinds of public and private policies to sustain productivity growth at a much higher level than in the past. To achieve this goal will require economic policies to sustain long-term economic growth.

We believe tax policies are an important part of what needs to be changed to achieve that improvement.

I have placed before you a study on productivity entitled Productivity Policy: Key to the Nation's Economic Future, which CED released last year. Much of what was said in this report remains valid today, and a good deal of what I am about to say rests on the analysis contained in this report.

This report, which was developed under the leadership of Bill May, former CEO of American Can and now Dean of the New York University School of Business, makes a thorough evaluation of the possible causes of the slowdown in the rate of productivity growth that had been going on in the United States for over a decade.

In this report, we concluded that the United States faced two serious productivity problems, either of which we believed constituted a serious threat to the nation's ability to compete internationally.

The first problem was the slowdown in the rate of productivity growth in the United States, which had fallen to the rate of nearly zero by the beginning of this decade before its current cyclical rebound. The second problem was, despite a general slowing in the rate of productivity among the industrialized nations, U.S. productivity growth remained significantly worse than that of our major international competitors.

The evidence is capsulized in figure 3 on page 15, and in figure 4 on page 17 of the CED study.

These figures convinced us that unless these trends were reversed significantly the United States was condemning itself eventually to becoming a second-rate economic power. Accordingly, we then undertook a review of the various asserted causes for the slowdown, which included such factors as:

- The decline through the '70s in the rate of capital formation in plant and equipment, as affected by levels of saving and investment.

- A generally low level of investment in non-defense research and development as compared to our trading partners.
- The changing composition of output between trade and services.
- The changing composition of the labor force.
- The dwindling availability of natural resources.
- Unfavorable government policies.

In addition, we investigated other possible factors, such as the excessive preoccupation of business with the short term, a perceived decline in the spirit of entrepreneurship, the debilitating effects of inflation, the apparent increase in nonproductive investments, the growing surge of protectionism, and a variety of others.

After considerable research and debate--which characterize CED's approach to issues such as this--we concluded that, while government can play a supportive role in improving productivity, the major responsibility for successfully turning productivity around lay in the hands of management and labor.

A prime area of focus needs to be on expanding the level of investment in plant and equipment. This study, as well as several others conducted by CED, convinced us that underinvestment in productive plant and equipment has been a major source of the productivity problem.

A second major conclusion that emerged from the study was that suitable government policy is essential to establishing the proper environment for these productivity-enhancing changes to occur, and that misguided government policy had indeed contributed to the slowdown in the rate of productivity growth during the decade of the 70s. In our report, we focused on two major areas of government policy: taxes and regulation. We felt that changes were required in both areas to allow any major improvement in productivity. In the area of tax policy, we concluded the tax code had inhibited the formation of critically needed plant and equipment, and also had somewhat negative effects on the level of R and D.

On page 47 of the CED report, figure 8 compares the level of capital investment in the United States to that of our major trading partners during the 1970-1977 period. As you can see, the rate of U.S. investment in manufacturing has been only about one-third that of the Japanese. Another way to look at this is to review the level of plant and equipment provided each worker, which has fallen from an annual rate of increase of 2.32 percent from 1960 to 1973 to a rate, since then, of barely 0.14 percent.

Although there have been some improvements of late, these have not been sufficient to spell a marked and sustained change in the overall trends--and unless something is done we will pay the price in flagging living standards and lower economic growth.

I want to point to two general areas in which tax policy affects capital investment and ultimately productivity.

The first is the general level of saving available to provide needed capital, the second is the level of productive investment.

In the area of saving, we have long been aware of the notoriously low rate of saving in the United States as compared to most of our major trading partners. As recently as 1980 the amount of disposable personal income devoted to saving in the United States was only 5.6 percent as compared to 21 percent in Japan and an average of 15 percent for our major European competitors.

In the paper on Productivity, CED applauded the recent liberalization on IRAs and interest rate available for small savings accounts. In general, the CED would support continued efforts to expand incentives in these and other saving-related areas.

The second area in which tax policy is important to productivity is its impact on incentives to individuals and corporations to make productive investments.

For example, with respect to marginal tax rates on capital gains, although ERTA reduced the maximum rate to 20 percent, the major disincentive, particularly in times of inflation, remains. Income from capital continues to be taxed on the basis of apparent rather than real gains on investment. One approach might be to adjust the value of an asset over a period of time through the use of the GNP deflator.

A second area of possible change involves ACRS. It would not come as any surprise that CED strongly supported the adoption of ACRS. In our view, ACRS and accompanying changes in the investment tax credit have helped reduce the cost of capital to all industries, which will contribute to the improvement in the rate of productivity in the United States in the future. However, ERTA worsened the already wide variance in effective tax rates among industries. And while some of this was reduced in TEFRA, CED continues to recommend a tax policy that is essentially neutral among industries.

One way to do this is to permit expensing of capital outlays. Adoption of expensing would permit eliminating a number of special business tax provisions, such as investment tax credits, as well as a general reduction in the overall corporate tax rate.

This latter idea, we must admit, poses the same kind of conflicting considerations that the tax-writing committees of the Congress so often have to wrestle with. It is a tax change that would encourage what we regard as a very important improvement: increasing the share of the nation's output devoted to saving and investment as distinct from consumption. But it would also probably involve a significant loss of federal tax revenue, at least in the short run, and thus deepen an already huge federal deficit that badly needs to be reined in.

For this and other reasons, therefore, we are strong supporters of a determined federal effort to achieve meaningful tax reform in the coming years.

To do our part to help that tax policy debate, we have commissioned a careful study to evaluate the relative advantages and disadvantages of several alternative types of reform of the federal tax structure. We expect to have it available around year-end, and we shall be glad to share it with you. We hope it can help not only ourselves but other concerned citizens and public policy-makers who are interested in achieving a tax structure than can better serve our combination of national goals.

* * *

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EXECUTIVE SUMMARY

PRODUCTIVITY POLICY
Key to the Nation's
Economic Future

This executive summary is based on a statement of national policy by the Research and Policy Committee of the Committee for Economic Development

April 1983

CED

EXECUTIVE SUMMARY

KEY TO OUR ECONOMIC FUTURE

For most of this century the United States has had the world's most productive economy. In the mid-1960s, however, U.S. productivity-growth rates began to drop sharply, and the decline continued into the 1980s. Unless this setback can be decisively reversed and a new era of strong productivity growth launched, the United States faces the serious prospect of lagging living standards, diminished competitiveness at home and abroad, and an endangered national security.

In this policy statement, the Committee for Economic Development analyzes evidence about the causes and consequences of the U.S. productivity problem, and recommends strategic steps that both the private sector and government can take to increase productivity-growth rates once again.

DOES PRODUCTIVITY GROWTH REALLY MATTER?

There is a direct link between productivity and living standards. To the extent that total hours worked and the ratio of workers to total population both remain constant, trends in per-capita income depend on changes in average output per worker. Growth in productivity will mean, in general, higher living standards and a better quality of life.

Productivity increases give business and industry the strength to compete at home and abroad. Persistently poor productivity performance forces industries and nations to win business through relatively lower wages and profits instead of through efficient, competitive ability.

Productivity growth also helps increase public support of and ability to pay for social and environmental programs and other public services, and it offers the potential, through more efficient utilization, to help conserve precious natural resources while reducing waste.

CAUSES OF POOR PRODUCTIVITY PERFORMANCE

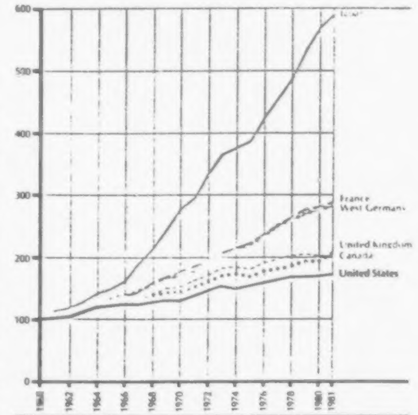
Careful analysis points to a variety of impediments to productivity growth. A low rate of investment in new plant and equipment has played a major role, with some studies attributing one half of the slowdown to this factor. Lower saving and insufficient investment have meant that factories have incorporated technical advances more slowly.

Government regulation has contributed to the problem. Meeting new standards in health, environment, and safety has reduced the growth of GNP by using resources that might otherwise have been channeled into more productive activities. Regulations have also increased business uncertainty and inhibited business decision making.

There are numerous other contributors to the nation's productivity dilemma, including inadequate research and development; a rapidly changing labor force; energy price increases and shortages; inflation; preoccupation of some managers with short-term goals to the detriment of longer-term strategies; an apparent decline in the spirit of entrepreneurship; instances of inattention to product quality; and growing domestic protectionism and other public policies that sap the competitive vigor of U.S. companies.

Manufacturing Productivity Growth, United States and Major Competitors, 1960–1981

(For each country, 1960 equals 100)



This graph compares the increase in each nation's manufacturing productivity from 1960 to 1981. It does not show relative levels of overall productivity.

SOURCE: U.S. Bureau of Labor Statistics, unpublished data.

PRODUCTIVITY: TWO SERIOUS PROBLEMS

The slowdown in U.S. productivity growth. From 1945 to 1965, U.S. productivity increased at an average annual rate of 3.2 percent. By the end of the 1970s, however, this average had fallen to below one percent per year. During 1979 and 1980 there was in fact no growth at all in U.S. productivity.

The poor U.S. showing in the productivity race. Since 1965, productivity has grown more rapidly in the economies of most of our major industrial competitors (see graph). Given time and the cumulative effects of compounding, the United States will lose its long-held overall lead in productivity. In some key sectors of the U.S. economy, we have already given up first place.

STEPS FOR MANAGEMENT AND LABOR

Although certain public-policy reforms are essential, the private sector—particularly top management—must take the lead in boosting productivity. No single approach will work for every firm or industry. Nevertheless, this Committee believes that broad adoption by U.S. companies of certain guiding principles could do much to reverse recent trends.

- **Raising productivity should be made a central goal of long-range business strategy,** alongside such objectives as improved profits, stock-price appreciation, and increased market share.
- **A portfolio of policies** ought to be established and explicitly evaluated for its sufficiency to achieve corporate productivity goals. Productivity-improvement actions can be more effective when they are coordinated.

- **Entrepreneurship, risk-taking, constructive criticism**—all of these need to be encouraged by management at every level, starting with the chief executive.
- **Real incentives, both financial and nonfinancial,** should be given to workers and managers to cooperate with one another and apply their skills and creativity to such long-run objectives as productivity growth.
- **Productivity performance, including that of competitors, should be closely monitored,** and the results made available to the appropriate personnel.

In applying these principles, a company can tailor its productivity programs to its own particular situation. This report examines the experience of several American firms that have made notable improvements in productivity. CED urges careful study of some of the more promising company applications, which include:

- **Gain-sharing systems** that tangibly reward productivity improvements or cost-saving measures by groups of workers;
- **Quality-circle programs** involving periodic meetings of workers to discuss ways of raising productivity;
- **Total work systems** that entail training employees to perform numerous related tasks, including making budgets and setting goals for their operation;
- **Labor-management participation teams;**
- **Improved employment-security programs** that permit flexibility in worker reassignment and retraining in the interest of increased productivity; and
- **Revised long-term management compensation plans** to incorporate rewards for sustained productivity improvement.

WHAT GOVERNMENT CAN DO

The market economy has the unparalleled ability to facilitate productivity improvements, but government policies and programs in recent years have impeded market functioning. To enhance the climate in which American industry can become more productive, CED believes that reforms are critically needed in four areas of public policy. Government needs to:

- **Spur saving and investment** by making the tax code simpler and less biased in favor of consumption. For example, government ought to expand the incentives for individuals to build up their retirement savings, and subtract from taxable capital gains that portion due to inflation. Relevant tax policies, however, should be made more neutral regarding investments in different industries. One way to move toward neutrality is to allow business to deduct immediately their outlays for new plant and equipment from taxable income. If this were done, some special tax arrangements for business would become unnecessary.

- **Provide productivity-enhancing support for private investment and output.** Governments should increase their outlays for the kinds of public infrastructure that play key roles in private-sector productivity performance.
- **Stimulate technological change** through dependable, multi-year funding commitments to basic research in universities, more flexible depreciation of assets used for applied research and development, and other measures to encourage innovation by small firms and entrepreneurs.
- **End unnecessary regulatory barriers to productivity growth** through continued deregulation of those aspects of trucking, airline, and railroad industries and public utilities that are now adequately disciplined by market competition. Other steps that are needed include applying more rigorous cost-benefit criteria to regulations; simplifying and accelerating approvals for "bubble" and "offset" programs governing pollution and allowing new plant and equipment to be included in these programs; and giving consideration to modifying antitrust laws that constrain productivity growth, with special focus on those that weaken U.S. competitiveness in global markets.

It may be, as some say, that the underlying fault in U.S. productivity performance lies in a decline in the spirit of workmanship and entrepreneurship. But even if that is true, surely that spirit only lies dormant, ready to be reawakened. Private measures by management and labor along with public-policy changes can contribute dramatically to the efficiency of every sector of the U.S. economy. The key to America's economic future will be found in the restoration of needed incentives and adoption of bold, imaginative productivity strategies.

STATEMENT OF LANA R. BATTS, MANAGING DIRECTOR, RESEARCH AND POLICY ANALYSIS DIVISION, AMERICAN TRUCKING ASSOCIATION, WASHINGTON, DC

Ms. BATTS. Thank you.

I am Lana Batts. I am the managing director for research and policy analysis of the American Trucking Association. ATA welcomes the opportunity to comment before your committee on the tax structure as it relates to productivity, and very specifically as it relates to productivity in the trucking industry.

Our statement today focuses upon three areas that we think illustrate just how the U.S. Tax Code fails to take into account or at least fails to encourage productivity among the different modes of transportation on an equal basis—and that's a word you have heard a lot today.

First of all, we are going to look at the accelerated cost recovery system and the investment tax credit, then I want to turn to productivity, and finally to an area which no one has yet addressed, discriminatory State taxes and how they are impacting upon productivity in Federal taxes.

Many incentives are built into the Federal Tax Code that are intended to encourage industries to improve productivity. Certainly the accelerated cost recovery system and investment tax credits are two major areas where the Tax Code is designed to promote productivity through capital investment.

Unfortunately, these incentives do not benefit all modes of transportation equally. The trucking industry, for example, has not realized the same benefits as other modes of transportation because of the basic nature of its productive assets—namely, trucks, tractors, and trailers.

Trucks and trailers have very short useful lives of 5 to 8 years, requiring them to be replaced much more frequently than rail, rolling stock, or aircraft. The ACRS provisions allow a more costly railroad locomotive which might have a 20-year useful life to be depreciated over the same 5-year life of a truck or a trailer.

Further, trucking companies receive only 6 percent of the investment tax credit on tractors, while railroads receive the full 10-percent tax credit on locomotives.

Tractors represent the trucking industry's largest revenue equipment investment, and under the ACRS rules they are depreciated over 3 years. Equity dictates that the motor carrier industry must have the option of claiming a 10-percent investment credit coupled with the 5-year tractor life.

Now, the cumulative effect of the inequities are clearly illustrated by the effective corporate income tax rate paid by railroads and motor carriers. According to a 1983 study conducted by the Joint Committee on Taxation, railroads have the lowest tax rate—2 percent—while trucking had the highest tax rate of 40 percent over the period 1980 to 1982. And of the rail and trucking companies surveyed, railroads had over twice the pre-tax income the trucking companies, yet those companies paid four times as much income tax as did their competitors the railroads.

Now, turning to productivity: Both the Motor Carrier Act of 1980 and the Surface Transportation Assistance Act of 1982, which you are very familiar with, both were intended to allow motor carriers to operate more efficiently and to provide better service. Yet, because our industry is less able to recover investment costs through tax incentives, the reduced cash flow limits the industry's ability to invest in new equipment.

Under the Surface Transportation Assistance Act, the trucking industry will pay $1.8 billion in additional Federal highway taxes annually.

Although the industry sees an offsetting net productivity gain, this productivity will not be experienced by all fleets. For example, carriers in the West already have the length and weight limits authorized under STAA. Their only gain was a mere additional 6 inches in width. While it would appear that carriers in the East had a significant gain, it was not until last week when the Federal Highway Administration issued it Final Rule on the designated highway system that carriers knew where they could operate this new equipment.

Unfortunately, even this very limited highway system is being challenged in the courts. Yet the trucking industry has been paying increased fuel and excise taxes since April of 1983 with no appreciable productivity gains.

As a result of STAA, operating taxes and licenses are the trucking industry's fastest growing expense item, and we have no control over them.

Finally, I would like to turn to the area of State tax discrimination, which has a very substantial impact on the productivity of the trucking industry.

A recent study conducted by the State of New York shows that many state taxes are inequitable. The study concludes: "Where railroads are not treated the same as motor carriers or air carriers for tax purposes, they are usually treated better than the other carriers."

The trucking industry is concerned about the rampant State taxation of its interstate activities. Transportation performed on an interstate basis probably has a greater exposure to tax discrimination than any other form of business activity.

Now, Congress has long recognized this danger, and it has provided Federal statutory protection against such discrimination for the airlines, for the railroads, and for interstate electric utility companies, but the trucking industry was unsuccessful as we sought similar protection in the Motor Carrier Act of 1980.

Thus, the motor carriers remain at a competitive disadvantage because railroads and airlines enjoy a prohibition against all discriminatory State taxation. The trucking industry does not.

In conclusion, as you have heard today, there are a number of corporate tax proposals being considered both in and out of Government as alternatives to the present tax system. Many of the arguments for the proposals are justified by three major conclusions which everyone seems to reach and we certainly have reached:

First, our current system is too complicated and too cumbersome, and it is further exacerbated by the major tax legislation occurring in each of the last 4 years.

Second, in the transportation industries our current system simply does not tax all corporations on an equal basis.

Finally, the present tax system unintentionally impacts productivity adversely.

ATA is examining the new tax proposals carefully. We welcome the opportunity to present in greater detail our analysis of these proposals at future hearings which we assume this subcommittee will be holding. We encourage this committee and the Congress to consider the merits of each of the proposals on the basis of fairness, equity, and productivity.

We believe that if the tax structure is chosen on this basis, then all industries will be paying their fair share. I think that is the purpose for these hearings today.

That concludes my remarks, Mr. Chairman.

Senator **GRASSLEY**. Thank you very much.

[Ms. Batts' written prepared statement follows:]

Statement of

Lana R. Batts, Managing Director
Research and Policy Analysis Division
American Trucking Associations, Inc.

Introduction

The American Trucking Associations, Inc. (ATA) welcomes the opportunity to comment on our present tax system as it relates to productivity in the trucking industry. This hearing provides the forum to to discuss this broad and complex subject which, of course, has major effects on trucking, the transportation industry and our economy.

ATA, with offices at 1616 P Street, N.W., Washington, D.C., is a federation with affiliated associations in every state and the District of Columbia. In the aggregate, ATA represents every type and class of motor carrier, both private and for-hire, which is impacted by the U.S. tax code.

Our statement today focuses on three areas that illustrate how the present U.S. tax code fails to encourage productivity among the different modes of the transportation industry on an equal basis:

(1) Accelerated cost recovery systems (ACRS) and investment tax credits related to shorter lived assets;

(2) Impact on productivity; and

(3) Discriminatory state taxation.

Accelerated Cost Recovery Systems and Investment Tax Credits

Many incentives are built into the federal tax structure that encourage industries to improve productivity. These incentives take many forms and are designed for different purposes. Two major incentives, the accelerated cost recovery system (ACRS) and investment tax credit, are designed to promote productivity through capital investment. The idea, of course, is that businesses will reinvest in those capital assets which are the means of their production at a faster rate if appropriate tax incentives are available.

Certainly, these tax incentives have contributed much to the productivity within the transportation industry. Accumulated deferred taxes as a result of these incentives are already a major source of investment funds for the transportation industry, and the percentage of assets financed by deferred income taxes is expected to rise sharply in the coming years.

Unfortunately, these incentives do not benefit all modes of transportation equally. The trucking industry, for example, has not realized the same benefits as other modes of transportation because of the basic nature of its productive assets, namely trucks, tractors and trailers. Trucks and trailers have short useful lives of five to eight years requiring them to be replaced much more frequently than rail rolling stock or aircraft. The ACRS provisions allow a more costly railroad locomotive which might have a 20 year useful life to be depreciated over the same five year period allowed for a truck or trailer. Further, trucking companies may receive only a 6% investment tax credit on tractors while railroads receive a full 10% credit on locomotives. Tractors represent the trucking industry's largest revenue equipment investment, and under ACRS rules are depreciated over three years. Equity dictates that the motor carrier industry should have the option of claiming a 10% investment credit coupled with a five year tractor life to the present system.

The cumulative effect of the inequities are clearly illustrated by the effective corporate income tax rates paid by the railroads and motor carriers. According to a 1983 study conducted by the Joint Committee on Taxation, railroads had the lowest U.S. tax rate, 2.0%, while trucking had the highest U.S. tax rate, 40.3%, for the period 1980-82. (See Table 1). Of the rail and trucking companies surveyed, the railroads had over twice the pre-tax income as did trucking companies, yet trucking paid over 4 times the income tax paid by the railroads. (See Table 2).

Impact on Productivity

The Motor Carrier Act of 1980 provided an opportunity for carriers to expand in areas and markets not previously served. The Surface Transportation Assistance Act of 1982 (STAA) has allowed motor carriers to begin to operate more productive equipment on a nationwide basis. Both of these acts were intended to allow motor carriers to operate more efficiently and provide better service. Yet because our industry is less able to recover investment costs through tax incentives, the reduced cash flow limits the industry's ability to invest in new equipment.

Under STAA, the trucking industry will pay an additional $1.8 billion in federal highway taxes annually. Although the industry may see an offsetting net productivity gain because of increased size and weights, this productivity will not be experienced by all fleets. For example, carriers in the west already had the length and weight limits authorized by STAA. Their only gain was an additional six inches in width. While it would appear that carriers in the east had a significant gain, it was not until last week when the Federal Highway Administration issued its final designated primary highway system that carriers knew where they could operate. Unfortunately, even this system is being challenged in the courts. Yet, the trucking industry has been paying increased fuel and excise taxes since April 1983 with no appreciable productivity gain. As a result of STAA, taxes are the trucking industry's fastest growing expense item, making it difficult for the industry to take advantage of productivity incentives offered by non-tax legislation.

Discriminatory State Taxation

Another tax matter having a direct impact on trucking industry productivity is discriminatory state taxation. State tax discrimination and the lack of uniformity among the states severely impacts the productivity of our industry. A recent study[1] conducted by New York state

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1. Taxation of Railroads, Other Transportation Companies, and Other Businesses: A Survey of State Laws, State Board of Equalization and Assessment, State of New York, August, 1983.

shows that many state taxes are inequitable as applied to the different modes of transportation in this country. This study concludes with the following:

> "Where railroads are not treated the same as motor and air carriers for tax purposes, they are usually treated better than the other carriers. With respect to motor carriers, railroads are treated better in the application of five types of taxes and fees; (real property, income or gross receipts, sales and use, capital stock and other taxes and fees) and are treated worse in the application of two types of taxes (personal property taxes and regulatory assessment)."

The trucking industry is concerned about rampant state taxation of its interstate activities. Transportation performed on an interstate basis probably has greater exposure to tax discrimination than any other form of business activity. Congress has long recognized this danger and has provided Federal statutory protections against such discrimination for the airlines (49 USC 1513) and the railroads (49 USC 11503). Similar protection has likewise been afforded to the interstate electric utility industry (15 USC 391).

The motor carrier industry unsuccessfully sought similar protection through the Motor Carrier Act of 1980. In 49 USC 11503a, Congress limited this protection to prohibit discriminatory property taxes only. Thus, motor carriers remain at a competitive disadvantage because railroads and airlines enjoy a prohibition against all discriminatory state taxation. As a result, for example, in New York State, a franchise tax on gross receipts of interstate transportation companies applies in fact only to motor carriers.

Conclusion

A number of new corporate tax proposals are currently being considered both in and out of government as alternatives to the present tax system. Many of the arguments for these proposals are justified by three major considerations:

(1) Our current system is too complicated and cumbersome which is further exacerbated by major tax legislation occurring in each of the last four years;

(2) In the transportation industries, our current system simply does not tax all corporations on an equal basis; and

(3) The present tax system may unintentially impact productivity adversely.

ATA will be examining new tax proposals carefully over the next few months. We would welcome the opportunity to present in greater detail our analyses of these proposals at future hearings of this subcommittee. We encourage this Committee and Congress to consider the merits of each of these proposals on the basis of fairness, equity and productivity. We believe that if a tax structure is chosen on this basis, all industries will be paying their fair share.

Table 1: Comparison of U.S. Income Tax Rate on U.S. Income by Transportation Industry 1980-82

Industry	1980	1981	1982	1980-82 Average
Airlines	3.0	(a)	(a)	(a)
Railroad	10.7	(7.5)	4.1	2.0
Trucking	37.5	46.1	36.9	40.3

(a) Rate not computed on book loss

Table 2: Comparison of Corporate Income Tax Rates By Transportation Industry, 1982
(000) omitted

Industry	U.S. Income Before Tax	Current U.S. Tax Expense	U.S. Tax Rate on Income
Airlines	(619,492)	(48,428)	--
Railroads	1,689,859	68,523	4.1
Trucking	837,646	309,310	36.9

Source: "Study of 1982 Effective Tax Rates of Selected Large U.S. Corporations," Joint Committee on Taxation, November, 1983.

Senator **Grassley**. Let me ask you to comment later on on the extent to which you can single out for us any negative impact upon your industry from taxes that are directed just at your industry, like some of the user taxes and the transportation taxes, as opposed to the general corporation tax laws. I think that would be helpful for our purposes, because I think, and maybe legitimately so, you argue that we have to look at all of the taxes impacting on your industry. But I think maybe all of the other testimony we have heard today as well as in the other two hearings have dealt with how personal income tax laws generally affect corporate decisions.

Mr. Holleman?

STATEMENT OF WILBUR D. HOLLEMAN, VICE PRESIDENT, TAX, THE FLUOR CORP., WASHINGTON, DC, ON BEHALF OF THE NATIONAL CONSTRUCTORS ASSOCIATION, WASHINGTON, DC

Mr. **Holleman**. My name is Wilbur Holleman. I am a vice president of Fluor Corp., and I am here on behalf of the National Constructors Association, which is a 30-year old organization of about 50 companies that we think are a major part of the service industry. Our membership does about everything in the world, but we are particularly characterized by the fact that many of our members are trying to compete overseas. We are an international industry, and we think we are one of the major contributors to a favorable balance of trade, which we don't have; but companies such as the Fluors and the Bechtels and many of the other companies have been very productive and very helpful to the general economy.

By the way, I was in law school when the 1954 code came out, and we got it in little paperbacks, because it was still coming out, and I thought it was incomprehensible. Little did I know. I look now, and in 4 years we will have had three major tax acts.

Tax law used to be a specialty. It ain't—it's a bunch of specialties now. It just boggles the mind. I mean, that's the way I make my living, but I deplore it. I deplore it.

Now, with respect to the service industries but with more respect to the contractors, we have felt that tax policy really hasn't been terribly neutral as against us.

For example, in ERTA, which I guess was the biggest tax cut in history, four-tenths of 1 percent affected our industry favorably, and that was the taxation of expatriates abroad. And we share that with other industries that have people abroad.

We are not a capital-intensive industry; we are a collection of people. We are basically labor companies, and our purchases of equipment for our own account are relatively small. So we are often failed to be recognized, and I want to talk about five specific areas:

One is the taxation of our people working abroad, our Americans working abroad. As you may know, on the Senate floor an attempt to emasculate 911 was fortunately killed. I hope it never rises again. I will say no more.

The second is foreign tax credits. And you, sir, are a cosponsor of Senate bill 1550 which deals with double taxation of the international service companies, where both the foreign country taxes us for what we do in this country and the United States taxes us for what we do in this country. And we effectively cannot offset them.

The next item I would like to mention just briefly in addition to section 911 on our people working overseas and the bill of which you are a cosponsor, is the taxation of our profits, which are less than they used to be but are still there.

Just 2 years ago the Congress went through a lot of agony in TEFRA on our traditional accounting method, which is called "completed contract." And some changes were made, but I gues it basically stayed there. We also have another traditional accounting method—not as old as that, but it is called "percentage of completion." And I would like the Congress to know that the Internal Revenue Service is continuing, despite the fact Congress looked at this, to attack us on the basis that a great deal of what we do is not construction. For example, they have ruled that painting is not construction; they are apparently about to rule that grading an excavation is not construction. So if you are not in construction you can't use percentage of completion, and they say you pay on two things: You pay on what you've earned, plus any moneys the client had advanced you—which you may not well have earned; you may have to return them, and you haven't incurred the offsetting expenses.

The next to last thing I would like to mention is DISC replacement. We favor that, but we feel, once again, the peculiar problems of the engineering construction business have been overlooked. We are not a manufacturing industry. We don't have the typical kind of sales office, and so forth. We would like the economic process and the foreign presence to recognize us for a change, so that we can make full use of them, because they are intended to help exports. We do help exports, and we need all the help we can get.

The last item is a little dinky item, which is payroll taxes. Since we are people companies, if you know the construction business, you are always transferring somebody from one job to another for any number of reasons. Usually this is though a different company. You own the company 100 percent, or 80 percent, or something. Every time you transfer one of these people, even if you own all of it, you double pay social security. It's a small thing, it would seem, but it is a major irritant and cost to our industry.

We thank the subcommittee and you particularly, Senator, for listening to our views.

Senator GRASSLEY. Thank you.

[Mr. Holleman's written prepared statement follows:]

STATEMENT
OF
WILBUR J. HOLLEMAN
ON BEHALF OF
THE NATIONAL CONSTRUCTORS ASSOCIATION
BEFORE
THE SENATE FINANCE SUBCOMMITTEE
ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

HEARING ON THE IMPACT OF THE FEDERAL INCOME TAX SYSTEM ON BASIC INDUSTRY, SERVICE INDUSTRIES, AND THE INVESTMENT INDUSTRIES

June 18, 1984

Mr. Chairman and Members of the Subcommittee:

My name is Wilbur Holleman, and I am Vice President - Tax of Fluor Corporation. I am pleased to appear before you today on behalf of the National Constructors Association ("NCA"). NCA has represented many of America's largest national engineering and construction companies for over 30 years. We presently have approximately 50 member companies, who are engaged in building major process plants and related facilities for electrical power generation; oil refining, chemicals and petrochemicals; paper, mining, steel and metals production and fabricating; and other major process and manufacturing needs here in the United States and abroad.

The U.S. engineering and construction industry is, and traditionally always has been, essentially a service industry. Our job is to provide our clients with the services of the most expert professionals in a variety of related areas, including engineering, design and planning; purchasing and expediting; cost estimating, scheduling and construction planning; construction management and overall project management; and field labor of all kinds. Our industry employs many white-collar professionals, as well as highly-trained blue-collar working men and women, both in the U.S. and abroad. The U.S. construction industry includes large international firms, as well as smaller, local or specialty businesses.

I personally have worked as a corporate and tax lawyer in a variety of positions in our industry for over 25 years. During that period I have witnessed, and to some degree participated in, vast historical developments in our industry, as well as major changes in the impact of the Federal tax law on the industry.

From my perspective, the U.S. economy, and the economies of our major trading partners in the developed world, are increasingly affected by service businesses like engineering and construction. Many economic and business observers have characterized the U.S., in particular, as fast becoming a "nation of service-providers." Certainly our increasing expertise in high-technology fields, science and professional services of all types has made the service sector of the U.S. economy a major growth area, today and into the foreseeable future.

Engineering and construction services play a major role within the service sector, and in the U.S. economy at large. Our industry is often viewed as a barometer of economic trends. In terms of innovation and advancement in technology, the applied engineering sciences are a key part of America's continued economic health, and our competitiveness in world markets.

Yet, the stark reality is that our Federal income tax law today is not favorable to service businesses. In fact, the tax law is not even economically neutral as between service enterprises and capital-intensive businesses: The tax law clearly disfavors the service industries. For example, the Economic Recovery Tax Act of 1981 ("ERTA") legislated a total Federal tax decrease for fiscal years 1981-1986 of approximately $749 billion. */ Of that amount, the

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*/ "General Explanation of the Economic Recovery Tax Act of 1981," Prepared by the Staff of the Joint Committee on Taxation, at page 380 *et seq*.

ACRS depreciation system -- which benefits only corporate businesses which invest heavily in capital goods and equipment -- was estimated to cost the Federal treasury over the same period approximately $144.2 billion, or about 20 percent of the total tax decrease. Engineering and construction firms purchase for their own account very few capital goods, and thus do not benefit from ACRS. The sole provision of ERTA directly benefiting service businesses, and in fact only those service companies which do business abroad, was section 911, providing a partial exclusion for foreign earned income of individual workers. As described below, that provision is intended to put U.S. workers on an equal footing with foreigners in competing for foreign projects. That benefit was estimated to amount to only about $2.72 billion, or about 1.9 percent of the ACRS benefit and about 4/10ths of 1 percent of the 1981 bill as a whole. Surely, the needs of the service sector were not adequately addressed.

While a portion of the 1981 ACRS benefits was taken back by Congress in 1982, nothing additional was given to service businesses. In fact, as discussed below, tightening of the completed contract method of accounting -- which impacts constructors and also certain high-technology manufacturers -- added a major dent in the service sector's tax posture.

We recognize of course that substantial tax reduction relief was given to individual taxpayers in 1981. However, that relief does not impact on service employers, including NCA's member companies. In sum, we must all recognize that while the corporate tax has been significantly lowered for capital-intensive businesses, on the other hand service businesses, such as engineering and construction, have not enjoyed anywhere near the same benefits.

However, let me be clear that in the face of the large budget deficits now confronting our country, NCA is not asking for tax relief. We only wish to portray accurately our tax burden as it now exists. We strongly believe that in 1985 and future years, when Congress addresses the need for fundamental tax reform, further burdens should not be imposed on us, relative to other business sectors.

There are, moreover, several specific problem areas we would like to highlight for this Subcommittee. These are very important areas, which we believe the Congress must address, and which do not involve any significant revenue costs to the Treasury.

1. Section 911. As noted above, section 911 -- which attempts to equalize the U.S. taxation of Americans working abroad with the tax treatment imposed by other nations on their citizens also working overseas -- is of critical importance to the U.S. engineering and construction industry. Our industry is one of the major employers of U.S. citizens in foreign countries, and our foreign construction projects have been an important component in U.S. export trade and the much-needed in-flow of foreign capital to the U.S.

Over the last decade the U.S. share of international construction awards has shown a dramatic decline -- from over 50 percent in the mid-seventies, to less than 30 percent in 1981. This loss in share has been picked up by European, Japanese, and South Korean companies who have increased their activities, particularly in the Middle East - the world's largest international construction market. For example, in 1975 the U.S. ranked first in engineering-construction sales to the Middle East with 45 percent of the awards. By the end of 1981, the U.S. was ranked third, behind Europe and South Korea, with only 20 percent of the market. During this period, Japanese and South Korean contractors raised their share of Mideast awards from 12 percent to 30 percent.

The existing section 911 provisions, which have been in effect since January 1982, were the product of four years of Congressional hearings and debate and extensive studies by both government agencies and private organizations. After this most careful and thorough consideration, Congress modified the tax law:

> "to encourage Americans to work abroad, in order to help promote the export of U.S. manufactured goods and services. It was decided that reducing the tax burden on Americans working abroad will make American enterprises more competitive in foreign markets. The Congress determined that a broad range of activities by Americans abroad serves to benefit the U.S. economy and should be encouraged." **/

Any significant changes in section 911 now, after only two years, would add greatly to the uncertainty and risks faced by U.S. companies attempting to do business in foreign markets and would discourage many U.S. firms that could and should be selling U.S. goods and services abroad from doing so. Moreover, at a time when U.S. trade deficits are mounting to $10 billion or more a month, no significant changes should be made in U.S. tax law that could adversely affect U.S. export performance.

**/ "General Explanation of the Economic Recovery Tax Act of 1981," Prepared by the Staff of the Joint Committee on Taxation, at page 43.

In this year's tax bill, a provision was stricken on the Senate floor, which would have substantially eroded section 911, creating grave competitive problems for U.S. firms, great uncertainty and unfairness. Fortunately, the necessity of leaving section 911 substantially unchanged was perceived in time. We commend the Senate for retaining section 911 in its present format.

2. Foreign Tax Credits. Generally, the U.S. foreign tax credit mechanism works well for the service industry. But in some circumstances involving foreign technical assistance taxes, double tax burdens are imposed on U.S. constructors. As noted above, we face stiffer competition abroad than ever before and cannot afford to have extra tax burdens. S. 1550 which is directed at this problem, and which is cosponsored by Senator Grassley, is a measure of vital importance to the future competitiveness of U.S. construction firms in international markets.

S. 1550 would solve this inadvertant technical error in the same fashion used by our major competitors (such as the U.K., Canada, Germany) by allowing a deduction as a cost of doing business. According to the Treasury's own estimate, this bill involves no U.S. revenue loss, and the industry believes it will raise revenues by as much as $100 million. Treasury also has recognized that the present mechanisms of U.S. law and the tax laws of many foreign countries (particularly developing nations) subject U.S. construction firms to potential international double taxation. As part of the pending tax bill this year, Treasury has agreed to provide the Congress this year with a detailed study and alternative proposals to solve this very serious problem. We urge this Committee to act quickly to remove the severe trade barrier of international double taxation.

3. Tax Accounting Methods for Service Businesses. In 1982, the Treasury Department asked Congress to abolish the long-term contract methods of tax accounting, which are the historical and natural methods used by our industry since the inception of the income tax law. Congress strongly disagreed with Treasury's proposals to repeal the methods or to substantially restrict their use. Following thorough debate and discussion, Congress determined to cure only certain specified and narrow abuses, but to once again sanction these accounting methods. See section 229 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").

Unfortunately, we believe some personnel within the Internal Revenue Service have failed to heed the Congressional mandate. Through administrative positions and rulings, the Service continues to attempt to disrupt and prevent the traditional and consistent use of these accounting methods. For example, a new IRS audit position is to deny traditional tax accounting methods to major portions of our industry. The IRS recently published a ruling that painting is not part of construction. Further, we understand that the IRS contemplates a similar ruling with respect to grading and earth moving. The effect of disqualifying major construction activities of our industry is to deny the use of both completed contract and percentage of completion accounting. IRS auditors are asserting that contractors report not only the profits they have earned, but also client advances which have not been earned and for which the matching costs may not have been incurred. Our industry is, and the Congress should be, disturbed at these IRS positions in light of the intensive Congressional review of contractor accounting methods in TEFRA. While we are not requesting specific legislation at this time, we believe Congress and staff should be aware of the continuing controversy in this area.

4. DISC Replacement. The proposed replacement for DISC in the Senate tax Bill will definitely help the balance of trade situation of the United States. The new Foreign Sales Corporation provisions, unfortunately, may fail to include adequately a number of critical service functions. Further, the economic process test in the bill is designed for manufacturing enterprises, and it should be relaxed to accomodate the service industries.

5. Payroll Tax Problems. Payroll taxes are a major burden of a service business. Yet the present rules do not facilitate the movement of employees from project to project, and in many cases involve the "doubling up" of payroll taxes as employees are moved. Also, the international aspects of the payroll tax lead to inordinate burdens. These matters should be addressed and excess payroll tax burdens mitigated.

* * *

In conclusion, NCA wishes to commend the Chairman and this Subcommittee for its attention to the service industries. We urge that a realistic evaluation of the tax posture of our industry and of our contribution to the nation's economic well-being be kept in the forefront of legislative consideration, this year and in the years to come.

Thank you.

Senator GRASSLEY. Before we go to the two questions that I previously laid on the table, let me ask you an immediate question:

You opened your comments with how complicated the Tax Code has become, and yet speak in terms of bills that are necessary, maybe to some extent making them even more complicated.

Are we driven to this, to be competitive? I mean, maybe making the Tax Code more complicated is the only way we are going to be able to compete as you must compete with your competition overseas.

Mr. HOLLEMAN. OK. Well, the two bills I stressed, or the two sections I stressed—really three of them—deal with our competing overseas, and that's a different environment. Section 911 deals with that, the double taxation of our services performed deals with that and DISC deals with that. So you are right, except we are talking there about competing in the international marketplace as opposed to competing and surviving in the domestic marketplace. I hope the United States has found out we can't redo the whole world; we are having enough trouble with our own country.

Senator GRASSLEY. Well, let's just suppose that we had the tax environment that we had when you were in law school. And even Senator Haskell spoke to this earlier, that most of the mistakes have been made since then, and he is blaming both Republicans and Democrats. Would we compete more effectively in that climate, with a less complicated corporation and individual Tax Code than we have today? Or would we be less competitive, just from the standpoint of the Tax Code affecting competition?

Mr. HOLLEMAN. Internationally, in 1954 there was one major trading company in the world. Internationally at that time there was one major technology company in the world. The world has changed since 1954, particularly overseas. I mean, who would have thought that we would be worried about Japan? My God, it was still in ruins. And Germany, and so forth.

So, internationally I think we should make our companies so that they can compete with the Germans, the Japanese, the Koreans, the Indonesians, countries that we don't normally think of.

Now, domestically—domestically—it would be a lot simpler, things would be a lot simpler, if we reverted to something that didn't seem simple at the time, the 1954 code.

I also want to mention, by the way, you know we have about 30 professionals. Somebody mentioned State taxes. I can't imagine how a small businessman deals with State taxes—they are all different. I mean, as far as I am concerned they can set their own rates, but every form is different, every method of allocation is different. You may have to file with three or four different groups in a State. I don't see how they can survive. My company can do it because we can pay people like me.

But the Congress ought to look at some kind of standardization—at least the rules; let them set the rates. This has got to be a major disincentive to the small businessman, all these forms he fills out, not just to the Federal Government. I don't know how they do it. I guess maybe sometimes they don't do it is how they do it. I see some people agree with me [laughing].

Senator GRASSLEY. Then we do need a more complicated Tax Code to compete?

Mr. HOLLEMAN. Internationally. Well, just a level playing field—I've been hearing that phrase a lot—because we do have competition over there, and we didn't in 1954. I mean there really wasn't. Plus, in 1954, because I used to do it, you could get tax exemptions from these countries, they were so happy to have somebody come in who had machinery and some know-how to help them rebuild and get something started. So the international marketplace has totally changed.

Senator GRASSLEY. Let's go back to John and Donald on the original question I laid on the table. Would both of you respond to that? Or if one can do it, OK.

Mr. MCCAMBRIDGE. Mr. Chairman, I will start out here, since John had a chance to go first last time.

I think the question was really whether we needed a dramatic change in the Tax Code to accomplish our objectives, and to restate the objectives of the steel industry, it is to gain equal access to the investment incentives.

I would say not. In fact, if you want to define "dramatic change," first in terms of the tax on goods such as the value-added tax or the national sales tax, this does not address our problem, because our problem is unequal access to incentives under the current income tax laws.

If you define "a dramatic change" as a flat-tax proposal, we found in examining those flat-tax proposals that have been put forth that in most cases they are biased against capital in that they extend the depreciable lives and eliminate the investment tax credits. I think most of them have that in common.

In addition, those flat-tax proposals that even some degree of graduation have tremendous transition problems if they did not take into consideration the balance of unused investment tax credits and net operating losses.

So, I think our objectives not only could be accomplished under the current laws, but it could be accomplished very simply, because the policy question has already been asked and has already been addressed. The policy question is: Should a corporation reduce its cost of capital by 10 percent when it makes an investment in a qualified capital asset? And that policy question has been answered in the affirmative—it should.

The other side of it is, should income and losses be rationalized over an extended period of time in order to recognize the cyclical nature of the business? And again, that policy question has been answered in the affirmative; we have a 19-year period in which we deal with the rationalization of income and losses.

All that's needed is a change in the timing of the access to those attributes, which would be revenue neutral over a period of time. And as bad as things are in the steel industry, as bad as they have been the last couple of years, during the 15-year carry-forward period we are going to utilize all of our net operating losses, and we are going to utilize all of our investment tax credits. It's on a first-in-first-out basis and over 15 years. If we can't utilize those losses and credits during that period of time, we've got a lot bigger problems than we know about right now.

So, therefore, I think all you have to do is address the question of when, and that could be done fairly simply under the current law.

Senator GRASSLEY. All right.

Well then, you know in a very real sense you are saying, within the existing tax law, particularly if we could change it in the manner you suggested so that individual corporations could take advantage of further unused tax credits, as an example, you are I think saying that the necessary overhead that you have from tax consultants and the economists who help your board of directors make decisions is a justifiable overhead and one which you can accomplish, and that there is no economic inefficiency from it. I mean, those things have all developed, we will say, since 1954, and they are an accepted part of the decisionmaking process and one in which you take a position different than the economists who say that that is an ineffective way to encourage investment.

Mr. MCCAMBRIDGE. Mr. Chairman, I think the economists are more inclined to concentrate on theory and less inclined to address what the real reasons are—in our case, anyway—what the real reasons are that capital additions have to be made.

Our machinery is wearing out. We have to replace it, otherwise we will lose a tremendous amount of the market share. And that is the reason we invest. We don't skew investments between short-lived and long-lived assets to get a tax benefit. It is appropriate economic theory, but——

Senator GRASSLEY. We can't take our thought process back 25 years, but if we could maybe we would admit that there were mistakes made 25 years ago, and that 10 years ago we realized they were a mistake, and after 10 more years, which would be about 2 years ago, we finally decided to make some changes. You know, if we had recognized that something was wrong then we maybe wouldn't have had to complicate the things the way we did.

So, all I am suggesting is, maybe we keep on correcting the mistakes of the past. It's kind of like a band-aid. Maybe we need some dramatic change of tax policy that would find us maybe even better off.

I am not sure that is a question to you, but if it were maybe it would be one that would be impossible for you to answer. I don't know.

Mr. MEAGHER. I would like to say something to that, Senator. I am one of these people who would personally demur on the idea of simplicity in the tax law. I think the tax law is a function of the complexity in our society. As we sit at this table, the businesses that are represented here are as diverse as the Members of the Congress that represent them. They have all sorts of problems that are unique to themselves, that relate to the kinds of activities, the kinds of competition they have, the kinds of equipment they buy, or the people they have, or whatever.

Just in this small panel here you have heard a diversity of problems cited. And when you go to the kind of a system that says we are going to do it all the same way, or very similarly, I think that you are going to encomater serious difficulties which while there is a great deal of talk about simplicity and the need to act quickly, in my view, little actual work on it has been done. In that connection, these kinds of hearings are very helpful. The dialog about what our system ought to be is important but it is asking questions rather than providing solutions.

I think you have to deal with the complexity in our society. It isn't going to go away; it isn't 1954 or 1913, it's 1984, and we have to look to 1990 and the year 2000 and where we are going to be in terms of productivity then. And I suspect we will find that we have a complex system and have to accept it. But we have to work through those problems before we jump to something, before we sort of throw the baby out with the bathwater. Our system isn't all that bad.

On the individual side, 70 percent of the taxpayers are on the short form, and the short form is really simple. The question that really has to be asked, it seems to me, is whether or not that 70 percent of the taxpayers are going to want to pay more to get the other 30 percent on the short form.

Senator **Grassley**. Would you go to the question that I had laid on the table for you?

Ms. **Batts**. Certainly. In terms of the way I addressed the testimony when we were looking at the trucking industry as a very specific industry, I think first of all from the Tax Code standpoint you are looking at an industry which has the highest effective income tax rate for corporations.

Now, it is one thing if other transportation industries that we competed with were equally high corporate income taxpayers, but we are not. Our nearest competitor ranks at the bottom of the list. Now, from a business standpoint it does end up affecting what we can charge in terms of rates and what they can charge in rates. We know we have to pay 40 percent to the Federal Government and the railroads only have to pay 2 percent.

And when we start looking at the other taxes which are not paid by other industries, as I indicated from the standpoint of the trucking industry, our fastest growing expense items are operating taxes and licenses, which is what is included in taxes with the Surface Transportation Assistance Act.

Now, it adds $1.8 billion to our operating taxes, but that is only on the Federal level. As you well know, Senator, each one of the individual States are now raising their taxes in order to match those increased Federal funds. Historically we have paid twice the rate on the State level as we have paid on the Federal level in highway user taxes.

I for one would not like to see that trend continue, but nevertheless we see it happening continually. Where a State used to have a $5 use fee, they now have a $25 use fee. And I am not talking about changes since 1954; I'm talking about changes since 1982.

We can't control that expense item, but it is our fastest growing expense item.

And then I think, finally, in terms of taxes as we look at it, them, in terms of small businesses and what has been happening with the States, we must recognize that trucking companies run in States that they don't vote in. Now, we heard earlier that corporations don't vote; well, let me tell you, out-of-State truckers don't vote in the States that are raising the taxes. And I imagine from a politician's standpoint, that is the most beautiful fantasy they can ever have, to raise taxes on somebody who can't vote for or against them. But that is what is happening to the trucking industry today, and we see it happening in State after State after State.

The association is putting a lot of money into fighting court cases in many of these States. We are usually successful, but it is taking us a long time and a good deal of money to reach that success, and the States continue to go against us.

So I think when you put all of these together, from the longrun standpoint of the trucking industry, certainly something has to be done in order to address the competitive standpoint within the transportation industries. It is one thing to say all industries and capital are all taxed differently, but when you take two industries that are so highly competitive, and the one is at the highest rate and the other is at the lowest rate, something is dramatically wrong, because somebody is not paying their fair share. I am not going to argue what that fair share is.

The other instance is where you have an industry that is going out into each individual State—and we have companies that are operating certainly in all of the 48 contiguous States and the District of Columbia—it is not only filling out the forms that is terrible, it is not only the fact that the calender quarters are not the same, it is not only that the due dates are not the same, it is the fact that an in-State trucker is benefiting from his vote and the out-of-State trucker is paying the penalty. That cannot continue.

Does that answer your question?

Senator **Grassley**. Yes, it does.

If you have a comment, go ahead. I was going to say, I am going to be finished with the questioning, because of time, and I probably will submit in writing some questions to each of you along the same line as I suggested to the previous panel.

Dr. **Holland**. I would be glad to respond to your comments in writing.

Senator **Grassley**. Did you have anything you wanted to add to any of these other comments? Because if you do, you can do that right now.

Dr. **Holland**. Well, I will add this much:

I think, looking at this picture broadly, the biggest problem we face is that for close to half a century we have evolved too much of a pro-consumption society. As part of that we have evolved a tax structure that encourages consumption too much. That is what we now face. The single most important change we need in the tax structure, therefore, is to redress the weight of that tax burden so it is not quite so encouraging to consumption and is a little less discouraging to saving and investment. And that is the essential theme that I would like to leave with you.

I believe you can make a fair degree of progress in that direction with the existing Tax Code, with the right kind of changes. But to make all the kind of changes sought, we think it makes a lot of sense to take a hard look at those—if I can use an old midwestern expression—"birds in the bush": value added, flat tax, and other new approaches. Consider along with them, how acceptable would be the kind of changes you would need to make in the existing Tax Code to be less burdensome on saving and investment. Look at them all together, and then decide which way we have to move. But we need to start working on that decision now and make it in the next year or two, I think, to serve our purposes well in this country.

Senator **Grassley**. All right. Thanks to each of you.

We have a Mr. Seaman who will be the first panelist to come. He is taking the place of a Mr. Harkavy. I would ask Mr. Seaman if he would give us his association when he starts is testimony. Then we have Frederick D. Hunt, executive director of the Society of Professional Benefit Administrators; Daniel J. Piliero II, ad hoc committee for a responsible tax policy; Stephen D. Driesler, executive vice president of the National Multi-Housing Council; and James P. Bryant, vice president and director of taxes, of the J.C. Penney Co.

I will ask you to start out, Mr. Seaman.

STATEMENT OF JAMES I. SEAMAN, OPERATIONS MANAGER, MASTER BUILDERS OF IOWA

Mr. **Seaman**. Thank you, Senator.

My name is Jim Seaman, and I am operations manager for the Master Builders of Iowa, a chapter of the Associated General Contractors of America, and the past president of the Iowa chapter of the Risk and Insurance Management Society.

I am here today on behalf of the Risk and Insurance Management Society, commonly known as RIMS, and I will refer to them that way.

RIMS is a nonprofit organization representing corporate, government, and institutional self-insureds and consumers of insurance in 76 chapters located throughout the United States and Canada.

The society commends this subcommittee for looking into the impact of the Federal tax system on corporate productivity. As risk managers, our deputy members are frustrated that the Tax Code, in recognizing only the purchase of insurance as a means of dealing with foreseeable risk, has forced them to do their jobs in what may not be the most effective manner. Often corporations will choose to purchase commercial insurance, rather than to partially self insure, even though the latter may be a significantly less expensive alternative. Why? Because only the purchase of commercial insurance qualifies for a tax deduction under the code. As a result, corporate development and competitiveness is hindered by a needless drain of capital. Consumers pay a higher price for corporate goods and services, and the U.S. Treasury is losing much needed tax dollars.

Recent years have evolved the computer, which enables us as individuals to do the work that insurance companies have previously done with people. As a risk manager, it is my job to devise the most cost-effective way to protect my employer from the risk of future losses. Whenever possible I will implement a loss-prevention program to eliminate or minimize these risks. On certain types of risks, particularly those of a catastrophic or unpredictable nature, the purchase of insurance is an essential means of protection. However, this is not always the case. We might find that our loss history for liability claims is relatively consistent at $50,000 annually for the past 10 years—we know we are going to spend that money.

We could purchase first-dollar insurance coverage that would indemnify the corporation for the full extent of its losses; however, this approach involves an expenditure by the corporation in the form of an insurance premium that exceeds the anticipated $50,000 loss by 100 percent. This is because the $100,000 premium reflects not only the anticipated $50,000 in losses the insurance company intends to pay out but its necessary profit, overhead, and commission expenses as well.

Moreover, depending on how we pay the premium, the insurer will have the cash flow and interest income of my corporation's premium dollar until the claim is paid.

Under such circumstances it makes more sense for us to self-insure such predictable risks. Having my own loss history in front of me, I can calculate—often with greater accuracy than an insurance company could—what our future losses will be. I have no need to pay an insurance company additional sums to indemnify my corporation for anticipated losses which I know will be incurred. And, not suprisingly, we would like to earn interest with these funds as the claims are paid.

One such technique of internal self-insurance funding is to establish a reserve for losses we don't know about, yet our loss history tells us they are there. This method acknowledges the existence of risk and creates a reserve on the balance sheet.

It should be emphasized that the practice of maintaining reserves is not only recognized but in essence mandated by the Financial Accounting Standards Board in its FASB standard No. 5. That states that highly predictable future payments arising from events that have happened, including self-insured losses, are to be charged to income in the current period.

Virtually every sizable corporation utilizes some element of self insurance similar to the risk management principles outlined above, yet the Tax Code permits a deduction only for premiums paid to a commercial insurer. The Internal Revenue Service will only let us take what we spent this year yet know we are going to spend it later.

I notice I'm getting closer to my ending time, and I've got a long way to go.

On a $600 million insurance premium, our people can pay $325 million for that, Senator. They can save $275 million. They can do that because we now understand the numbers business, and what is unfair about the Tax Code is saying that here is an insurance company that does $15 million in premiums a year that's going to pay out between $6 and maybe $15 million in losses. Here, we have a corporation whose risk manager is handling $15 to $17 million a year in losses and is going to pay them out over a perfectly predictable path, provable to any IRS agent that would like to sit down with us and visit about this thing; and yet, we are not allowed to hold that reserve past December 31. So, it's pretty unfair.

If the computers had not occurred we wouldn't have a chance of doing this in business over a long stretch. If you think about the $275 million which this corporation saved, it is possible that the Federal Government might pick up its tax share on that $275 million that is not needed to pay the claimants.

So, we would like to ask that we get the same tax treatment as the insurance industry does if we can prove those losses. We have to carry them on our balance sheet; we'd like to move that over into the tax treatment.

Thank you.

Senator **Grassley**. Thank you.

All right, Mr. Hunt?

[Mr. Seaman's prepared statement follows:]

Risk and
Insurance
Management
Society, Inc.

TESTIMONY OF THE RISK AND
INSURANCE MANAGEMENT SOCIETY,
INC. (RIMS)
THE UNITED STATES SENATE
FINANCE COMMITTEE'S SUBCOMMITTEE
ON OVERSIGHT OF THE INTERNAL
REVENUE SERVICE
ON
THE IMPACT OF THE TAX SYSTEM
ON BASIC INDUSTRY SERVICE
INDUSTRIES, AND THE INVESTMENT INDUSTRIES
GIVEN AT
A HEARING HELD ON JUNE 18, 1984,
9:30 A.M., RM SD 215, DIRKSEN
SENATE OFFICE BUILDING

205 EAST 42nd STREET, SUITE 1504, NEW YORK, N.Y. 10017 (212) 286-9292 • Telex [illegible]

This statement submitted for inclusion in the printed record of the United States Senate Subcommittee on Oversight of the Internal Revenue Service's hearing on the Impact of the Tax System on Basic Industry, Service Industries, and Investment Industries, is given on behalf of the Risk and Insurance Management Society, Inc., commonly known as RIMS. RIMS is a non-profit organization representing corporate, governmental, and institutional self insurers and consumers of insurance in 77 chapters located throughout the United States and Canada. Corporate members include over 90% of the Fortune 1,000 list.

The Society commends this Subcommittee for looking into the impact of the federal tax system on corporate productivity. As risk managers, our deputy members are frustrated that the Tax Code, in recognizing only the purchase of insurance as a means of dealing with forseeable risk, has forced them to do their jobs in what may not be the most effective manner. Often the corporation will choose to purchase commercial insurance, rather than to partially self insure, even though the latter may be a significantly less expensive alternative. Why? Because only the purchase of commercial insurance qualifies for a tax deduction under the Code. As a result, corporate development and competitiveness is hindered by a needless drain of capital. Consumers pay a higher price for corporate goods and services, and the United States Treasury is losing much needed tax dollars, as will be explained below.

The following brief explanation of the risk management process will bring this issue into sharper focus. Until relatively recently, most corporations handled their business risks by relegating the purchase of insurance to a clerk. The clerk shopped around until he or she found what was hoped to be the right coverage at the most competitive price. Occasionally, a company purchased too little insurance, but, in general, the corporation was adequately protected.

Unfortunately, as business risks escalated, it became more difficult to buy insurance to cover these exposures. Premiums for standard coverages have risen astronomically, and many insurance companies simply refuse to cover high-risk operations. The field of risk management has evolved under these circumstances of growing corporate and governmental liability exposure.

Risk management is the process of planning, organizing, directing and controlling the resources and activities of an organization to cost-effectively minimize the adverse effects of accidental losses on that organization. In the last 10 years, risk management has evolved from infancy to maturity, and most top corporations now give high priority to risk management programs.

As the role of risk management and its practitioners has grown, so has the status of the risk manager; from a clerk relegated to the purchase of insurance to an expert on risk identification, risk measurement and evaluation, risk elimination or reduction, and risk finance. Obviously, not all risk can be eliminated, and it is the risk manager's charge to devise the most economically efficient means to deal with an organization's risk of loss. It is this process, risk finance, which is rapidly changing the insurance industry.

Today, an increasing number of corporations are financing a major portion of their losses internally, particularly when such losses are relatively frequent and predictable. "First dollar" insurance purchases,in which coverage is obtained for the full extent of the loss, is becoming rarer. A brief example explains why.

A supermarket chain might find that its loss history over a 10-year period for "slip and fall" tort liability claims is relatively consistent, approximately $500,000 a year. The corporation could purchase "first dollar" insurance coverage that would cover the corporation for the full extent of its losses. However, this approach involves an expenditure by the corporation in the form of an insurance premium that exceeds the anticipated $500,000 loss. This is because the premium reflects not only the anticipated $500,000 in losses the insurance company intends to pay out, but its profit and overhead as well. In this situation the field of risk management comes into play to determine what type and percentage of risk should be assumed internally and, similarly, to determine the type and percentage of risk that would be more economically efficient to cover with the purchase of commercial insurance.

One such technique of internal funding is to establish a reserve for expected losses. This method acknowledges the existence of risk and creates a reserve on the balance sheet. The IRS has recognized this technique in Code Section 537(b)(4), which allows the accumulation of reasonable product liability loss reserves, without subjecting the reserve to a tax on unreasonable accumulation of earnings. It should also be emphasized that the practice of maintaining a reserve plan is not only recognized but, in essence, mandated by the Financial Accounting Standards Board (FASB) in its FASB Standard Number 5 (FASB-5). FASB-5 states that highly predictable future payments arising from events that have occurred, including self-insured losses, are to be charged to income in the current period. This directive reflects the FASB's concern that predictable losses should be reflected on the corporate balance. sheet.

Virtually every sizeable corporation utilizes some element of self insurance similar to or based on the risk management techniques and principles outlined above. Yet the tax code permits a deduction only for premiums paid to a commercial insurer. Similarly, the

Internal Revenue Service insists on an external transfer of risk before such a deduction is allowed. Such an approach is not in the best interests of corporations, government or consumers.

On a microeconomic level, such an approach does not encourage cost effective behavior by the corporate community. To illustrate, a risk manager faced with the decision to reserve $50,000 for predictable losses or to purchase insurance at a much higher price, may choose the latter in order to qualify for the tax deduction. This type of decision, made by many corporations, has a tremendous impact on the national economy.

In terms of the federal budget deficit, it should be made clear that it is the U.S. Treasury that loses when the corporate decision to purchase commercial insurance is made for tax motivated reasons. First and foremost, the Subcommittee should be aware that a significant portion of the deduction for insurance premiums allowed under the code reflects the profit, administrative and overhead expenses of the insurance company. That portion of the cost that the corporation would seek to deduct as self insurance would lower the deduction now obtained through the purchase of insurance, because neither the profit nor overhead is included. Thus a lower deduction would be claimed by the corporation reserving for predictable losses than by its counterpart purchasing first dollar insurance coverage.

An added and not insignificant benefit to the Treasury is the fewer losses incurred by self insureds. An editorial in the noted trade publication Business Insurance (Nov. 22, 1982, page 8) stated, "It is quite clear from the experience in the United States that a company that pays its losses out of its own pocket in the first instance is more serious about controlling losses than the fully insured company." Companies that self insure are aggressive about loss prevention, because the losses are felt directly on the corporate bottom line. Besides the tremendous benefit to society of fewer injuries and losses, the fiscal impact on the United States Treasury is clear. Fewer losses mean fewer deductions; and fewer deductions mean more tax dollars taken in.

While the government has certainly been a loser because of the Tax Code's refusal to recognize reserving practices as eligible for a tax deduction, the corporate community and the consumer have been hurt as well. Congress and the courts have been enlarging the scope of corporate responsibility in almost every area, from product liability to toxic waste. This has not been without ramifications. The greater the liability exposure the higher the cost of securing commercial insurance coverage, if such coverage is available at all. These higher insurance costs are passed on to the ultimate consumer of the insured corporation's products and services. Moreover, the development of new products and services can be hindered because of the excessive cost of insurance coverages for new risk exposures created by technological advances. Similarly, corporate funds are being devoted to securing insurance coverage at the expense of much needed capital investment. This in turn has a detrimental impact on the competitiveness of American Industry.

It must be recognized that the corporate community cannot economically meet its growing legal responsibilities solely through the purchase of commercial insurance. A viable mechanism for self insurance is essential to deal with these enlarged loss exposures. A qualified self insurance program permits the corporation to lower insurance costs that would otherwise be passed on to consumers. It encourages the development of new products and services by providing an affordable mechanism to insure against certain risks. It frees funds devoted to insurance purchases for much needed capital investment. Most importantly, self insurance,combined with the purchase of insurance coverage, allows the corporation to secure the broadest coverage at the least cost. Given these facts, it makes no sense to exclude qualified self insurance reserves as a permissable tax deduction. Unfortunately, what we have now is Congress and the Courts expanding corporate liabilities in areas that may extend well into the 21st Century, and a tax code that recognizes only 19th century means to meet these responsibilities.

To rectify this situation, RIMS urges this Subcommittee to reform the Tax Code to permit corporations who elect to self insure certain types of risks to receive, with respect to self insurance reserves, the same tax treatment as if they opted to purchase commercial insurance. One partial step that the Committee can take to achieve this tax equity would be to treat self insureds and insureds the same, allowing a deduction for the value of all claim liabilities. As the reserves of the self insured and commercial insurer serve the same purpose and are subject to the same claim liability, there is no rational reason in differentiating them for tax purposes. This conclusion, though restricted to the area of workers' compensation, was reached by the United States District Court for the Northern District of California in Kaiser Steel vs. the United States, 82-2USTC 9635 (N.D. Cal. 1982).

While RIMS believes that such an incremental step toward achieving equality for the self insurer would be most useful, we would also urge the Committee to consider the more comprehensive approach taken by Representative Bill Frenzel in H.R. 2642, introduced on April 20, 1983. The bill permits a tax deduction for certain self insurance reserves or set-asides and helps provide the assurance that the taxpayer will be around to pay these loss claims when they become due. The key to this bill is tax equality; one class of taxpayer, the self insurer, is treated the same as another taxpayer class, the buyers of insurance. With respect to self insured reserves, they would be treated in the same manner as reserves established by commercial insurers.

In order to qualify for the tax deduction under H.R. 2642, the loss reserve funds must be set aside in:

1. A self-insurance trust that would be somewhat comparable to the trust arrangement that presently exists under Section 501(c)(9) of the Code and is used to provide coverages for certain employee benefit programs.
2. A standby trust supported by an appropriate surety bond or letter of credit. This same approach was proposed in connection with certain environmental liability programs by the Environmental Protection Agency.
3. Affiliated insurers , or so-called "captives". H.R. 2642 wording follows the definition for affiliated insurers found in the Federal Risk Retention Act.
4. Unaffiliated insurers,- Which are commercial insurers that administer programs for the insured that contain substantial elements of self insurance.

The test for tax deductibility under an affiliated or unaffiliated insurer's program would be directly related to premium. If held in a trust, it would be based on amounts determined in a manner acceptable to the Secretary of the Treasury. The bill also permits amounts to be set aside based upon determinations made by an independent and qualified actuary or loss reserve specialist. The amount set aside may also be based on an amount equal to 90% of what the taxpayer would have to pay a commercial insurer for coverage of the taxpayer's current liability for self-insured losses. This amount would be determined on the basis of a quotation from a licensed insurance carrier or brokerage firm.

There would be an annual recalculation of the liabilities covered by the trust at the end of each year to determine the adequacy of the reserves. In the event of a surplus, the excess in the reserve would be repatriated to the self insured and treated as gross income for tax purposes.

If the trust approach is used, the taxpayer's ability to terminate the trust is strictly limited. Termination is only permissible when:

1. The taxpayer has not taken a deduction for losses self-insured through the trust in any of the five previous tax years .
2. There are no outstanding claims of liability with respect to the risks the taxpayer self-insured through the trust .
3. The applicable statute of limitations has run out on all risks self-insured through the trust, or the risk is transferred to a licensed insurer.

These stringent termination conditions are designed to protect potential claimants by providing safeguards that the taxpayer will be around to pay loss claims when they become due. RIMS urges this Subcommittee to consider the approach taken in H.R. 2642 as a responsible solution to the needs of the public, American industry and the United States Treasury. It would provide the necessary framework in the Tax Code for the Kaiser case to be implemented with certitude, consistency, and fairness by the Internal Revenue Service. It would encourage the formation of sound financial arrangements for the payment of potential claimants. It would eliminate the dysfunctional incentive to purchase potentially more costly commercial insurance to obtain a tax deduction. This would benefit the Treasury, as a lesser deduction for insurance would be taken by the corporate taxpayer than if it had purchased commercial insurance. It would simultaneously benefit the business community, because it would free capital used for the purchase of insurance to meet vital operating needs and capital investment requirements.

On the other hand, what does the status quo offer? The present federal system of taxation, by restricting the ability of a corporation to deduct funds reserved on an accurate basis to pay predictable future losses, ratifies inefficency as a tax policy goal and creates a tax inequity between self insureds and commercial buyers of insurance. The cost to our economy is a permanent inefficiency because corporations will not be able to freely choose whether to self insure or to procure commercial insurance based on economic considerations.

As a result, corporations may pay more for a service, "insurance", which they could more efficiently handle internally. Consumers in turn, pay more for goods and services. Ironically, the Tax Code, by refusing to recognize the deductibility of self insurance loss reserves, has discouraged the use of a risk financing alternative that would net the government additional revenue by lowering corporate insurance deductions.

In conclusion, RIMS stresses that we testify before this Subcommittee today, not as a special interest group looking for tax avoidance loopholes, but as a Society representing deputy members wishing to engage in their profession as risk managers in the most effective manner possible. Reforming the Tax Code so as to give the risk manager that ability would benefit the consumer, potential claimants, the government, and American industry.

STATEMENT OF FREDERICK D. HUNT, JR., EXECUTIVE DIRECTOR, SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS, WASHINGTON, DC

Mr. HUNT. Thank you, Mr. Chairman.

My name is Fred Hunt, and I'm executive director of the Society of Professional Benefit Administrators. I prefaced my written remarks with some background on who and what SPBA and our members do, so let me just say that we are the national association of independent third party benefit administration firms, and it is estimated that one-third of all U.S. workers and a slightly larger percentage of their dependents, and retireed, are covered by plans administered by such firms. That makes us the most comprehensive voice, we believe, in the employee benefits community, because we represent employee benefit plans, employers of all sizes and types, unions, and workers.

With your permission, let me take an extra few seconds to clarify what might seem contradictory testimony with Mr. Seaman's. We actually happen to agree.

He and RIMS are referring to property casualty insurance and prohibitions against self-funding of that. We of SPBA work with the human risks of health insurance, disability, pensions, et cetera. We have been allowed to have self-funding in this field in Internal Revenue Code, Section 501(c)(9). It has worked very well. I should even point out that it not only saves money for business but it has also made a lot of extra tax money. So, we are talking about different things, but it would seem to support what he says.

Let me explain that employee benefits are to business what the Department of Health and Human Services, including Social Security and medicare, et cetera, are for the Government. It is the way for conscientious employers to take care of their workers.

Interestingly, one of the largest beneficiaries of private employee benefit plans is Uncle Sam.

Through costshifting and direct replacement of benefits, the private benefit system saves the Government each year millions upon millions of dollars, and I might say, probably more than any revenue loss. Nevertheless, like the Department of Health and Human Services in the Federal budget, the Treasury estimates that employee benefits are the largest revenue loss—I think that's the term—because of current established tax policy.

That, naturally, is a tempting target for tax authorities, even though pursuing that target, as I mentioned, is really shortsighted and would end up costing the country more in revenue and also in lost productivity.

I commend the committee for having these hearings, and our comments apply to all of the hearings that you have had and all of the businesses.

One of the points on which we would specifically commend you is the use of the term "tax system," though the committee obviously is theoretically just for IRS oversight. I think that the IRS probably gets more blame than they deserve. They are often the thing that first comes to mind.

Let me explain, if I may, who we are referring to as the "tax system" and "tax authorities": Obviously the Internal Revenue

Service, the Department of Treasury, but also a very important player in the policy—everybody has been complaining about all of these new rules and instability—have been the staffs of the Joint Committee on Taxation, and the House Ways and Means Committee, and I have the unhappy task of having to say even the Senate Finance Committee.

One of the problems that we find is the exact genesis of a lot of the counterproductive actions and proposals is usually purposely obscured, with each of the groups I have mentioned pointing the finger elsewhere and saying, "No, they wanted it." The final product is often a piece of legislation which nobody really wanted and nobody needed, and it's counterproductive.

One of the sad things is, I often find that the actual Members of Congress and the industries who are made to suffer the various overkills that I have been mentioning, are often the last to know what the true goals or secret agendas might be that are going on. Thus, I think we have to look at the tax system as everybody who has their finger in the pie.

We can summarize our report on the tax system with three simple points:

First, that the tax system for the past 5 years or so has been guilty of destructive overkill and severe destabilization, which is about to take its toll. I have been told repeatedly on issues that such overkill and destablization is not a mistake, but that it has been a legislative tactic—which again means that you and we are the pawns.

Senator GRASSLEY. Are you talking about just the number of bills that have passed?

Mr. HUNT. No, sir. Often, for example in the VEBA legislation that happens to be in conference now, the original reason was that people were discussing, "Oh, the abuses." There was a very simple remedy. By removing three words from the IRC description of VEBA's you could have cut all of the abuses immediately. That could have been the end of it. It turned out as things went on that, "Well, no, it wasn't really the abuses." And it went on and on and on. These are the sorts of things. We are told, "Here's what we are going to try and solve," and then it ends up being something else. You know the expressions "throwing the baby out with the bath water," or "hitting with a baseball bat instead of a flyswatter," those sorts of things, those are the of comments I hear.

One of the problems is that the tax excesses are often sneaky, and it is also perceived by the public and by business as an undeserved punishment or discouragement, and that's a problem.

I talk to thousands of businesses and workers every year, and the natives are getting restless.

The second point is that the IRS and other tax authorities are out of line with the other 70 or so responsible agencies who govern employee benefits. In fact, not just out of line but diametrically opposed. Employee benefits are unique because they have mandated coequal regulations by many agencies. All of those authorities are united in their opinion and work toward stronger, well financed benefits. They are responding to the true worry of underfunding for promised future benefits; but the shortsighted tax people are looking at, "Gee, how can we add a few dollars to this bill or this proposal?" They are suggesting less funding, which puts us in the middle. Of course, this situation is ludicrous, and it makes Congress look foolish to the people like risk managers and those who run businesses. We feel we're damned if we do and damned if we don't, as to providing employee benefits.

The third and last point relates to the first two, that there is no national policy, despite 70 different agencies, on employee benefits. I think that you must decide if employee benefits are a worthwhile national goal. Every Congress and every administration of every political persuasion have felt so, and, in fact, where benefits were perceived to be missing, new benefits were either created or mandated, such as Social Security, medicare, et cetera, and this has been a cost-effective national goal.

Now, the problem that we have found is, if, indeed, this is something good, we would have to ask, "Please, Senator, call off the dogs." We are really being hurt. The effect of this constant tax harrassment is devastating.

You asked about corporate decisions. I find one of the things we have heard here, we are finding more and more businesses saying, "This is too much trouble; let's dump the employee benefits. Let them go into Social Security and medicare." You won't get any extra revenue for that, either, you know. They will blame it on Uncle Sam. That's what's right around the corner.

So, in conclusion, we can report that the tax system, including all of the components, not just the IRS, is guilty of misguided overkill. We can also report that Uncle Sam, as we say, "speaks with forked tongue," with 70 agencies saying one thing and the IRS or the tax authorities saying the other.

Finally, we would ask that there be an end to this counterproductive activity by establishing a uniform national policy.

Thank you, Senator.

Senator GRASSLEY. Yes.

I want to thank you for your very outspoken statement as to what is wrong, and we would hope that where things are clear like that it will be very definite by anybody else who testifies not only at this hearing but at any future hearing.

Mr. HUNT. Thank you, Senator.

Senator GRASSLEY. All right, I think the next person is Mr. Piliero—and I hope I have pronounced that right. Go ahead.

[Mr. Hunt's prepared statement follows:]

SPBA SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

TESTIMONY OF THE SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS (SPBA) TO THE UNITED STATES SENATE COMMITTEE ON FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

JUNE 18TH, 1984

THE IMPACT OF THE TAX SYSTEM ON BASIC INDUSTRIES, SERVICE INDUSTRIES, & INVESTMENT INDUSTRIES

SPBA is the national association of independent third party contract benefit administration firms...often nicknamed "TPAs". It is estimated that one-third (1/3) of all U.S. workers and dependents are covered by plans administered by such TPA firms.

SPBA members operate much like independent CPA or law firms...providing continuing professional out-of-house claims and benefit plan administration for client employers and benefit plans. Most of the plans employ at least some degree of self-funding (self-insurance) usually via an IRC section 501(c)(9) trust. Client plans include those sponsored by corporations of all sizes, associations, and union/management jointly-administered Taft-Hartley multi-employer plans.

SPBA membership has been growing consistently at an annual rate of 100%...with a current roster of almost 300 member firms. Similarly, SPBA members have seen the market for their services also expand rapidly...in large part because of the leading role SPBA members have played in successful cost-containment efforts and cost-efficient administration techniques for health and pension plans.

Mr. Chairman, my name is Frederick D. Hunt, Jr. I am Executive Director of the Society of Professional Benefit Administrators...more simply known as SPBA. We appreciate the opportunity to appear today, and we commend the Committee for looking into this important (and often neglected) question of the impact of the tax system on industries and the economy.

Our comments apply to all of the industries under consideration today. In fact, they apply also to small business and the other areas of the economy you are studing in this series of hearings. You see, the basic, service, and investment industries are actually composed of employers with unionized workers, management, private corporations, and cities/states as employers in those industries. There is also the question of employee benefits sponsored by trade associations for the employees of member companies, who could not achieve cost-effective basic benefits any other way. All of these are suffering attack from the tax systems for providing needed coverage.

James M. Dawson, President James M. Dawson Associates, Manchester, NH
Robert B. Swanke, Vice President Swanke, Inc., Minneapolis, MN
John Timmer, Secretary/Treasurer Employee Services, Sioux Falls, SD
W. Richard Perkins, Immed. Past President Executive & Employee Benefit Plans, Atlanta, GA
Robert J. Cardinal MICA, Chicago, IL
William C. Earhart William C. Earhart Co., Portland, OR
Robert C. Gerald Group Services Administrators, Jersey City, NJ
W. Ashley Harden, Harden & Company, Walnut Creek, CA
Russell R. Naylor Comprehensive Benefits, Newtown Sq. PA
Frederick D. Hunt, Jr., Executive Director
Past Presidents Council: Robert E. Kelly • Steven L. Sherman • Charles B. Jackson • Glen K. Slaughter

One very important point which you should draw from these hearings is that despite what might be the best of intentions...the tax system is quilty of overkill. Repeatedly, you will hear analogies such as "throwing the baby out with the bath water", or "using a baseball bat as a fly swatter". Yes, there has been some mis-use of exotic benefits in employee benefit plans. (I think you will find our members more rabidly against these abuses than the IRS.) Anyone who is experienced in the employee benefits business could explain some easy administrative or "surgical" maneuvers which would permanently curtail those abuses. However, what normally emerges is a Rube Goldberg proposal. Ironically, these obtuse schemes, whether they come from the IRS, the Joint Committee on Taxation, a private member of Congress, or (more commonly) a combination of those...the net effect usually does not achieve the desired goal of stopping the abuse. Nor, ironically, does it usually net the desired revenue.

We recognize that it is the responsibility of the IRS and other tax authorities to collect adequate revenue. We do not argue with that. In fact, in any proposals we have ever suggested, we try to make sure that the net revenue collected would be greater under our idea than under the IRS proposal. That should be a deal they can't refuse...but whether because of bureaucratic inertia, professional vanity, or non-public "agendas", our revenue-raising or abuse-defeating proposals are rarely adopted. That inevitably leads some to feel that the official revenue reasoning which is stated to Members of Congress and the public may not truly reflect the desired goal. Adding insult to injury, many of these rules, legislative proposals, and changes are implemented in what can only be perceived as a sneaky manner.

The second important point which you should draw from these hearings is that the tax authorities are out-of-step with the other governmental agencies and Congressional committees who share co-equal authority over employee benefits and the industry employers who sponsor employee benefits. As you know, under the ERISA law, the Department of Labor, Pension Benefit Guaranty Corporation (PBGC), and the Department of Treasury hold co-equal cooperative authority over employee benefits. There are also about 70 other governmental agencies, such as Medicare, EEOC, Social Security, etc. who also exercise some authority over employee benefits.

You should be aware that the Tax authorities...including some members of the Senate Finance Committee...stand alone against that host of over 70 responsible government agencies in their impact on employee benefits. While all of the other government agencies and Congressional authorities are responding to the public desire for stable well-funded employee benefits...the IRS and Tax Committees of Congress have had a never-ending stream of rules and proposals which hinder, cripple, or discourage employers and employees. I have often taken the short walk from the IRS or Treasury to the Department of Labor, PBGC, or Department of Health & Human Services. I am always amazed to hear responsible authorities at one end of the avenue state "the" national policy on employee benefits which is diametrically opposed to "the" national policy as expressed by the IRS/Treasury. I know that you get caught in the same whiplash here in Congress. You have the PBGC currently expressing dire warnings about the degree of under-funding of employee benefit plans. The Department of Labor lobbies to strengthen the benefit plans and to assure adequate coverage for employees. Meanwhile, the exact opposite effort is underway from those involved in the tax system. We have always assumed that if about 70 government agencies and Congressional Committees agree on one national policy, they are more apt to be right than the tax authorities who stand isolated with their diametrically opposite view. This would all be a funny joke if it weren't the vital health and retirement of most of the nation's population which was being bandied about. Thus, I hope that this hearing can create a consistent national policy...either by converting the 70 or so other government agencies...or convincing the tax authorities that they are out-voted by a ratio of 70 to 1.

The basic question which creates all of this furor is: Are basic employee benefits for health, disability, and pensions still a worthwhile national goal? By the way, since you are examining the entire scope of taxation, I am including Social Security, Medicare, and benefits for government employees in this question. They are inextricably related for the purposes of your comprehensive study and findings.

Historically, Congress and all modern Administrations have certainly thought that reliable cost-effective health, disability, and retirement coverage is a top-priority for the nation. In fact, where coverage was perceived to be missing for some Americans, government programs were formed...leading to the birth of Social Security, Medicare, Medicaid, IRAs, and the vast expansion of the benefit plans covering Federal employees. Thus I don't think anyone can argue with the premise that employee benefits are a desirable national goal supported by repeated Congresses and Administrations of every party and political persuasion.

Mirroring the growth of government-sponsored employee benefit plans, the private sector established and expanded the employee benefits which were offered to employees and their dependents. Since private benefits plans significantly lessened Federal expenditures for public benefits, there has never been any question that benefits should be deductible as a business expense to the paying employer and tax free (or deferred) to the employee.

Government policy has also strongly encouraged or insisted that these private benefits be adequately funded for future eventualities. That is the primary activity of the Department of Labor's Office of Pension & Welfare Benefit Plans (OPWBP) and the Pension Benefit Guaranty Corporation (PBGC). Even today, these two government agencies and the Congressional committees with jurisdiction over employee benefits are demanding stronger benefit plans and more money put aside by employers now for later promised benefits.

The real worry today is underfunding and under-reserving. Private employee benefit plans must not only face the same inflation and problems which have bankrupted the Government plans such as Medicare and Social Security...but private plans must also constantly assume more and more of Uncle Sam's liabilities. This is known as cost-shifting. For instance, Medicare does not pay its fair share of medical expenses...so private plans and patients are charged significantly more to make up the difference.

Employee benefits have grown rapidly in recent years. This is due not only to the governmental pressures already mentioned...but also because basic health, disability, and related basic benefits have become prohibitively expensive or unavailable for individuals and small groups. A recent study of the cost of basic health coverage provided by a traditional insurance company cost 71% more than the same coverage in a self-funded IRC 501(c)(9) employee benefit plan. Thus, there are two misconceptions: First, that all brands of insurance coverage for the same risks cost the same. That is not true. Second, there is the misguided belief that such cost-effective health care is available at every corner insurance agency. That, too is not accurate. I confess that until I became an employer myself, I never realized just how tight the market is. Right here in Washington, DC I asked several friends in the insurance business, who had proved themselves very capable, to come up with some suggestions. There were few, and, the agents were candid enough to tell me that they cost too much for what I would be getting. So, when you hear those wonderful ads about the Wausau, Nationwide, and other insurance companies "taking care of all of your business needs"...they are *not* referring to basic cost-effective employee benefits.

The strength of the private sector employee benefit plans has also proved to be very valuable to the Federal government. The millions of workers who receive privately-paid employee benefits are not thrust onto the financially troubled government plans, such as Medicare, Medicaid, and Social Security. Also, there is cost-shifting...in which some of the responsibilities of government-sponsored programs are shifted to private plans to pay.

That is the good news...how private employee benefit plans are strong, needed, and have been able to forestall the financial disaster of government programs. However, in recent years, since about 1979, the Department of Treasury and some legislators in Tax Committees in Congress have proposed or implemented restrictions which can only be interpreted as "punishment" of the workers and/or the employers trying to provide basic coverage. Meanwhile, the rest of the world, tells us we should be doing more. We feel damned if we do and damned if we don't provide strong basic benefits.

Why have the tax authorities taken this isolated stance? Simple...MONEY! Employee benefits, I understand, are considered the largest "revenue loss" by the Treasury/IRS...reportedly about $50 billion a year (with pensions representing about $30 billion of that amount). Obviously, limiting private benefit plans is a false economy, since much greater demands would be put onto government plans such as Social Security, Medicare, and Medicaid. Also, limiting timing of deduction until current benefits are paid or a funding system similar to that used by Social Security and Medicare...would rapidly cause the same bankruptcy for private plans which those government plans currently suffer.

I should point out that money in employee benefit trust funds does not sit idly by. It is estimated that over *1/4 of the total investment capital* which makes this country function comes from employee benefit plans. The investment policies and procedures are *very* carefully monitored by the Department of Labor, so *this is a very positive force in the economy*...not some sinister activity.

We understand that many tax authoriries feel that even if all tax advantages were removed for employee benefit plans, employers would continue to provide benefits anyway. *Don't count on it!* A significant number of employee benefit and insurance plans would be terminated and not replaced. That, of course, would mean that Social Security and Medicare would be swamped almost overnight, and there would be no other recourse than huge amounts of subsidy to those funds from General Revenue. Since Social Security, Medicare, and Medicaid are generally viewed as being less cost-efficient than private employee benefit plans...you must recognize that any move that hinders or eliminates employee benefits will cause a huge increase in government spending. We are surprised that too few people have thought that far ahead to the true consequences of this seemingly "easy" answer.

If tax advantages were hindered or eliminated, pressure to terminate coverage would come from two sides. First, young healthy, and lower-paid workers would far prefer ready cash rather than the vague concept of health and retirement security...especially if there is no tax impetus for the coverage. Ironically, it is these same people who face the most devastating financial crisis if an accident or illness should strike. Just ask the Social Security and Medicaid folks what it costs now for those types of people, and how they would like millions more like them. Upon the withdrawal of the young and healthy workers, only the old and the sickly remain in the plan. This drives the cost of the cverage up and up...finally making it impractical. In insurance terminology, this is know as "anti-selection".

The other pressure to terminate the plan would come from the employers. While members of SPBA are in the business of trying to make employee benefit plans efficient and less complex for sponsoring employers, our SPBA members would be the first to tell you that more and more employers are getting fed up with the red tape and expense. Many employers would love to be able to drop the hassle and expense of providing benefits to employees...and blame Uncle Sam.

In closing, we would say that the current impact of the tax system on the employee benefits of basic industry, service industries, and the investment industries is divisive and destabilizing. Either the 70 other government agencies are correct...or the isolated view of the tax authorities is right...but they can no longer continue this destructive tug of war. This agreement on government policy should apply both to administrative issues and funding policy. Do you want us to avoid the problems of under-funding which have plagued government plans? As part of that decision and the larger question of setting a national policy, you should consider whether the Federal budget could absorb the huge health and retirement costs which would descend upon the government if the tax system continues to be a tool to nibble away at the private benefits system. The private employee benefit system works for millions upon millions of Americans. It is cost-effective in its own operations, and has more than paid its own way in saving Federal programs. As Burt Lance would have said, "If it ain't broke, don't fix it."

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STATEMENT BY DANIEL J. PILIERO II, AD HOC COMMITTEE FOR A RESPONSIBLE TAX POLICY, WASHINGTON, DC

Mr. PILIERO. That is correct, Senator, and thank you very much. My name is Daniel Piliero. I am president of the Ad Hoc Committee for a Responsible Tax Policy. Senator, we appreciate the opportunity to testify.

The Ad Hoc Committee for a Responsible Tax Policy is mostly concerned with the impact of the Federal tax system on the investment community and how in the investment community it backwashes into the basic and service industries.

The ad hoc committee was organized with the primary goal of presenting to the Congress the views of taxpayers who have concerns about the proposed changes in tax laws. The initial impetus and financing for the committee came from taxpayers who are members of the investment and business communities throughout the country. The committee is not a membership organization; it's primary goal is to devote attention to responsible tax reform.

Few people would argue against the need for reforming the present Tax Code in the direction of simplification and equity. It is very important to try to streamline the "tax system; however, achieving real and lasting tax simplification is far from a simple matter.

Congressman Conable observed in an article in the New York Times in June of this year that the "tax system today is more equitable than it was 20 years ago." According to Mr. Conable "it was that equity which creates the complexity, and after a while the complexity itself carries with it the perception of unfairness, although it is not necessarily so."

According to Congressman Conable:

> The popular current flat tax proposal involves not just one rate for everybody but an exclusion for poor people, then a rate of 14 to 28 percent, graduated twice, plus the retention of the biggest and most popular tax preferences—the charitable deduction, mortgage interest deduction, and the real estate tax deduction. This is designed to raise about as much income tax as we are currently raising, or $200 billion less than we are spending annually. All economic income would be subject to tax.
>
> To compare, you have to look at both sides of the current income tax, also. As is widely noted, some wealthy engage in heavy tax sheltering; but on average, according to Treasury, the top 10 percent pay 50 percent of the income tax revenues. The next 40 percent pay 40 percent. The bottom 50 percent pay 10 percent of the total taxes. That is the profile of a progressive system, based, as intended, on ability to pay.

I am quoting Congressman Conable.

> Reducing the maximum rate from 50 percent, where it currently is, to 28 percent, as proposed, would have the tendency to shift the figures towards the lower end of the economic scale; that is, to lower tax burdens for the rich and to raise them for the less rich. Are we willing to pay this price for simplification?

Our position essentially is quite similar to that one. We basically believe—and I think that Secretary of the Treasury Regan last week commented in a similar fashion when he said that the flat-rate tax issue has been and continues to be "a snare and a delusion and, that it generally was going to be" in his view, "unfair and inefficient."

In our judgment, Senator, the flat-rate tax which has been proposed, commonly known as the Bradley-Gephart proposal, would be very injurious to investment and to business. It would be regressive, it would tax fringe benefits, it would tax deferred and retirement benefits at their market values, it would have an impact which would be very adverse to capital formation activities such as real estate, home ownership, construction, insurance, and domestic oil and gas exploration. There would be an inevitable reduction in charitable contributions. There would be an adverse effect on the market ~~value~~ of collectibles and an adverse effect on municipal bond funds and a distorition of investment incentive for jobs creation.

Our goal would be to achieve simplification in much the fashion in which we have been proceeding. As has been suggested earlier, 70 percent of Americans are on the short tax form. To suggest that the 30 percent who are on the long form are in circumstances in which they cannot be improved would be arguing with the obvious. But to suggest that going to a flat-tax solves the problem, we think is equally incorrect.

As has been suggested by a number of those testifying here today, if we are talking about somebody else's tax situation, he probably doesn't need the tax benefit; "but mine" is different. The trucking people or others, can explain to you quite clearly why it is that they are being hurt—or the VEBA people, or whatever.

We believe that the Tax Code is complex because we have a complex society. We very strenuously urge—and we have submitted a longer statement and will submit more information to the committee at the Senator's request—we would very seriously urge the committee to be hesitant about moving to a flat-rate tax proposal, because we think it would eliminate significant and much needed investment.

One example. One of our members alone did $2 billion worth of real estate construction in the sale-leaseback area, which is now an area which is up in controversial debate. That particular area, during the period when interest rates were 18 and 20 percent, probably created more jobs in Iowa and across this country than any other particular provision of the Tax Code, and all it did was provide tax benefits which would have been in the hands of people who couldn't have used them and put them in the hands of Americans who were willing to make investments and take a chance. And some of the construction didn't work out, and they lost.

But now, as we are looking at it with hindsight, "that may not have been a wise tax policy."

We have come through the recovery essentially because there were incentives created for job creation, for investment, for risk-taking. That is what has made our country great and, before we go and scrap it with some mechanistic flat-rate tax, we welcome the opportunity to testify before your committee, which we know is giving serious consideration to the deeper impact of such proposed changes.

Thank you, Senator.

Senator Grassley. Yes.

Mr. Driesler.

[Mr. Piliero's prepared statement follows:]

Testimony of

Daniel J. Piliero II
President
Ad Hoc Committee for a Responsible Tax Policy

Before the
Senate Finance Committee
Finance Oversight Subcommittee

June 18, 1984

The Ad Hoc Committee for a Responsible Tax Policy appreciates the opportunity to appear before this Committee to address the impact of the federal tax system on basic industries, service industries, and the investment community.

The Ad Hoc Committee was organized with the primary goal of presenting to Congress the views of taxpayers who have concerns about certain proposed changes in the tax laws. The initial impetus and financing for the Committee came from taxpayers who are members of the investment and business communities throughout the country. The Committee is not a membership organization. Its primary goal is to focus attention on the concerns of taxpayers in the investment community and to support responsible tax reform.

Few people would argue against the need for reforming the present tax code in the direction of simplification and equity. It is very important to try to streamline the tax system. However, achieving real and lasting tax simplification is far from a simple matter. In an interview in the New York Times on June 6, 1984 the Honorable Barber B. Conable observed that the tax system today is more equitable than it was twenty years ago. According to Mr. Conable, it is that equity that creates complexity. "After a while the complexity itself carries with it the perception of unfairness, although that is not necessarily so."

ANY TAX REFORM MEASURE MUST BE CAREFULLY CONSIDERED AND THOROUGHLY EVALUATED TO ASSESS ITS IMPACT ON BUSINESS AND INVESTMENT

The Ad Hoc Committee for a Responsible Tax Policy sees significant changes ahead, as early as next year, in our federal tax system as a result of the Presidential and Congressional directives to simplify the individual and corporate income tax. As the Committee members know, the Department of the Treasury is undertaking a comprehensive tax reform study and will be presenting its findings and recommendations to the Administration this December. A number of tax reform measures are being explored in this study: a flat-rate tax, a value added tax; a consumption tax; and a national sales tax.

Of these reform measures, the so-called flat-rate tax concept has received considerable attention. However, a closer look at the flat-rate tax theory reveals the significant adverse impact that such a tax would have on business and investment. Because the federal tax system impacts so dramatically upon our business and investment communities, we believe that a dialogue focusing on the consequences of such a possible tax reform measure is warranted, and indeed, is critical to any discussion about how the federal tax system impacts industries and investments.

Simplification of the tax system and the concept of a flat-rate tax are completely separate issues. While it is desirable to close loopholes in order to reduce tax rates, this can be accomplished without the massive shift in tax burden involved in a flat-rate tax. The Honorable Barber B. Conable posed two very interesting questions at one of the Ad Hoc Committee's briefings: Why don't we try to evolve from our present system and not go through the disruptive process that is involved in total repeal and then re-enactment? Why go through that disruption if you can take some steps that would improve the public perception of your existing tax law?

THE FLAT-RATE TAX CONCEPT HAS A DIRECT ADVERSE CONSEQUENCE ON BUSINESS AND INVESTMENT

The so-called flat-rate tax would eliminate the basic productivity in our tax system and create additional tax burdens for business and taxpayers. Additionally, either (a) revenues would be lost from the overall effect of a lowering of taxes whereby increasing the deficit or (b) important incentives to American business that create jobs would be lost by a tax system that does not recognize the entrepreneurial spirit and the entrepreneurial activities of Americans. We believe that certain fundamental changes in the American free enterprise system being offered in the name of simplicity would deleterious. In fact, Treasury Secretary Regan addressed the flat-rate tax issue recently and acknowledged that such a tax "is a snare and a delusion" and that a flat tax was unfair and inefficient.

Specifically, the adoption of a flat rate tax system or a modified flat rate tax system would result in the elimination of many exemptions, exclusions, deductions and credits that are available under a current tax law and would have a dramatic adverse impact on the entire tax system. Individuals and corporate taxpayers who have followed the design of tax policymakers and legislatures and engaged in tax preferred activities with the expectation of receiving continuing or future tax benefits would also be severely and adversely affected. If Congress and the Administration contunue to believe that certain investment activities should be encouraged, that particular activities should be promoted or prohibited, and that needy individuals should be protected, then current tax benefits would have to be replaced with direct cash subsidies or other legislative relief. If government encouragement is completely withdrawn from a particular economic activity that has historically received encouragement through the current tax system, that activity can be expected to be adversely affected and, in some instances, almost completely eliminated.

Deborah H. Schenk, a visiting professor at the New York University School of Law and a member of the Section of

Taxation of the American Bar Association, wrote a very comprehensive article in the April 23, 1984 issue of Tax Notes.

Professor Schenk considered the likely effect of broad-based, flat-rate taxes on ordinary taxpayers and concluded that: "Supporters of a flat-rate tax are promising more than they can deliver." Additionally, Professor Schenk found that such a system was not likely to be either equitable or simple, and she cautioned that adoption of flat-rate taxes would introduce a host of new problems in the tax law: "Enthusiastic support of the flat-rate idea based on an unproven premise of simplicity and fairness is unwarranted," according to the Professor. Merely because one is against complexity and inequity does not mean that one should automatically be for a flat-rate tax."

An article by John Zimmerman, a certified public accountant specializing in tax work, recently published an article, The Flat Tax: A Closer Look. Mr. Zimmerman expressed his belief that tax reform measures such as a flat-rate tax would actually "be of the greatest benefit to those in the higher income brackets." Mr. Zimmerman commented on the myth that the rich avoid paying taxes through loopholes and observed that the myth "has taken on an aura of an irrefutable truth" when "[t]he evidence, however, shows quite a different story". For example, Mr. Zimmerman noted that "Congress and the courts have been closing off the more abusive shelters" and that while there are very few left, "there may yet be substantial benefits from these investments; however, they involve great risks and, if the investment is a poor one, then the losses will be greater than the tax savings." As Mr. Zimmerman so correctly pointed out: "If an activity can be shown not to be engaged in for profit and its only purpose being tax writeoffs, then expenses can only be written off to the extent of income earned from that activity. Excess expenses cannot be netted against other income. On the other hand, if a tax shelter turns out to be a wise investment, then taxes will have to be paid on the income earned from the shelter."

With respect to the argument that the present progressive rate system encourages people to invest in wasteful tax shelters and that a flat rate tax system would encourage people to invest their money more productively, Mr. Zimmerman noted: "In fact, I believe just the opposite is likely to happen. Most tax shelters are centered around real estate development and oil and gas exploration. Far from being 'wasteful' our economy depends to a large extent on construction and energy development. People in a 50 percent tax bracket are encouraged to risk their capital in such ventures because they know many of the initial costs can be written off against taxable income through real estate depreciation or oil and gas intangible development costs. If, after one year, the venture is profitable and they decide to sell their interest, they can get favorable captial gains tax treatment with a maximum tax rate of 20 percent--though sometimes part of the gain may be taxed as ordinary income."

A SUMMARY OF JUST ONE FLAT-RATE TAX PROPOSAL, THE "FAIR TAX ACT," REVEALS THE DRAMATIC ADVERSE CONSEQUENCES OF SUCH A MEASURE

Consider, for example, the extraordinary ramifications that just one of the pending tax reform proposals would have on the business and investment communities and on individual taxpayers. The "Fair Tax Act" would include the following as "income" for the average taxpayer.

a. Money paid by the employer for group term life insurance.

b. The amount of premiums paid in by an employer.

c. Annual increase in cash surrender value of life insurance policies.

d. Interest on IDB and mortgage subsidy bonds.

e. Unemployment compensation.

In addition, under the provisions contained in the "Fair Tax Act" there would also be:

a. Significant limits on the amount of interest deductions for individuals.

b. Repeal of accelerated cost recovery system depreciation and special leasing rules that are helpful in business and which create jobs.

c. Repeal of special capital gains treatment for individuals and corporations.

d. Repeal of partial income tax exclusion for interest and dividends.

The "Fair Tax Act" would do away with favorable capital gains treatment, repeal percentage depletion and expenses of intangible drilling costs for oil, gas and geothermal wells, and eliminate the exclusion for employer provided premiums on health insurance.

The proposal would substantially revise the depreciation system for equipment and structures by placing equipment in one of six classes according to its Asset Depreciation Range (ADR) mid-point and structures would have a class life of 40 years.

With respect to real estate, the proposals would lengthen the useful lives for depreciating rental property to 40 years and eliminate the current system of tax reduce rate taxation for long term capital gains. Other changes would eliminate all tax credits for the preservation of historic and other buildings and would end federal tax exemptions for locally issued mortgage bonds as well as industrial development bonds issued after December 31, 1984.

In addition, the "Fair Tax Act" would significantly affect the oil and gas leasing industry by repealing both the expensing of intangible drilling costs and the allowance for percentage depletion. Instead, intangible drilling costs and costs now recovered through the depletion allowance would be written off under the same capital cost recovery method applicable to equipment in the ten year class. Dry-hole costs would be deducted when the well or property is abandoned.

It is evident from the above analysis that such a tax reform measure would seriously impair the incentives to invest in productive but risky enterprises such as real estate, oil and gas, and corporate stocks because high income taxpayers would no longer be willing to risk their capital when the incremented tax rate is low. It would be much easier and safer for those individuals to put the money into treasury bills or savings accounts. Therefore, those capital formation industries would be adversely affected because the proper and reasonable incentives for investing in those industries would be removed from the tax code.

CONCLUSION

The Honorable Barber B. Conable summed up the issue very well in one of his recent Washington Report newsletters. Congressman Conable noted: "The popular current flat tax proposal involves not just one rate for everybody but an exclusion for poor people, then a rate of 14-28%, graduated twice, plus the retention of the biggest and most popular tax preferences--the charitable deduction, mortgage interest deduction and real estate tax deduction. This is designed to raise about as much income tax as we are currently raising, or $200 Billion less than we are spending. All economic income would be subject to tax.

To compare, you have to look at both sides of the current income tax also. As is widely noted, some wealthy engage in heavy tax sheltering; but on average according to Treasury figures, the top 10% pay 50% of the income tax revenues, the next 40% pay 40% and the bottom 50% pay 10% of the total taxes. That's the profile of a progressive system based as intended on ability to pay. Reducing the maximum rate of tax from 50% where it currently is, to 28% as proposed, would have the tendency to shift the figures towards the lower end of the economic scale; that is, to lower tax burdens for the rich and to raise them for the less rich. Are we willing to pay this price for simplification?"

Certain problems are inherited in a flat-rate tax concept as a vehicle for tax reform. These problems include:

a. Regressivity.

b. Current taxing of fringe benefits.

c. Taxing of deferred and retirement benefits at their market value.

d. Adverse impact on capital formation activities, such as real estate, home ownership and construction, insurance, and domestic oil and gas exploration.

e. Inevitable reduction of charitable contributions.

f. Adverse effect on market value of correctables.

g. Adverse effect on municiple bond funding.

h. Distortion of investment incentives for job creation.

Careful thought and much analysis is necessary so as not to sacrifice productivity in the name of simplicity.

STATEMENT BY STEPHEN D. DRIESLER, EXECUTIVE VICE PRESIDENT, NATIONAL MULTI-HOUSING COUNCIL, WASHINGTON, DC

Mr. **Driesler**. I am Stephen Driesler. I am the executive vice president of the National Multi-Housing Council and I am delighted to be here today.

We are here to testify on the impact of the Federal tax system on the investment community in general, and on the impact of investment in rental housing in specific.

The flow in investment capital into rental housing is strongly dependent upon tax incentives. Without the incentives that are now in the tax law, the rental housing industry would be unable to effectively compete in today's capital markets.

The simple fact is that, with today's high cost of money, land, and materials, market rate rents are generally not high enough to support a return on investment that is competitive with investments in other assets. Thus, Congress has consistently recognized that tax incentives were both necessary and desirable as a means of enhancing the attractiveness of investment in rental housing.

Now, the question is: Why won't market rents, without these additional tax incentives, work in our society today? And obviously that is a complex question; but there is one simple answer.

We have talked a lot today and have heard a lot of testimony in support of a neutral playing field, that is, of tax rates being neutral. But as long as we have the major distortion in housing in the Federal Tax Code in this country toward single-family ownership, rental housing in this country is always going to be at a competitive disadvantage.

The largest single housing subsidy the Federal Government provides is the tax incentive for single-family home ownership—the ability to deduct mortgage interest, real estate taxes, as well as to defer almost indefinitely any gain recognized by the sale of a single-family house, makes it the largest used tax shelter in America today.

In 1981 the cost to the Treasury of the single-family home tax incentives exceeded $35 billion. Now, we recognize that there are a lot of public policy reasons, valid reasons, for maintaining these tax incentives for home ownership.

Our members are not necessarily saying that those tax incentives should be changed; but all we are saying is that we have to recognize these incentives distort the housing market, and make rental housing less competitive. Therefore, we need some counterbalancing in the Tax Code to provide incentives for investment in rental housing, and to be able to keep rents down and affordable.

At a time when we are all recognizing the necessity of reducing the Federal deficit, we also have to look at the reality of meeting the housing needs for all Americans, not just homeowners. We need apartments, we need rental housing, to provide the shelter needs for low- and moderate-income Americans who cannot afford a single-family home or, for whatever reasons, choose not to buy.

Now, Mr. Chairman, those needs are starting to be met. I am here to tell you that the tax incentives the members of this committee have put into the Tax Code to encourage development and production of rental housing are working. For the first time in over a decade we are starting to see significant increases in the production of rental housing—market-rate rental housing We are seeing jobs created, we are seeing housing shortages being abated. Unfortunately, this improved climate may not last. Some of the provisions which are now before conference having to do with partnership provisions, having to do with time-value of money and accounting changes are already having a negative impact. We are already seeing investors less willing to put their money into rental housing.

Now, if the private sector cannot attract the capital necessary to build and maintain apartments, or if the cost of that capital is so high as to price those rents above what the average renter, who has an income of less than $10,000, can pay, who is going to provide the housing needs for American tenants? And the answer is, "No one."

Another question: Who is the ultimate beneficiary of the tax provisions that relate to rental housing? The answer to that is, "Those who rent."

This point was underscored recently by a study done by the Department of Housing and Urban Development entitled "Federal Tax Incentives for Rental Housing." That HUD study found, and I quote,

> Given the competitive nature of the rental housing market, it is likely that most of the benefits of rental-specific tax provision accrue to renters.

The study went on to point out, and again I quote:

> While the owners of rental property may benefit themselves in the short run from favorable changes in rental tax provisions; however, an enhanced rate of return will attract more investment and lead to lower rents than would be obtained in absence of favorable change. Since renters have lower incomes than other households, the tax benefits that lead to these decreased rents tend to be progressive in nature.

In summary, Mr. Chairman, rental housing's ability to compete in the capital market is dependent upon carefully conceived and longstanding advantages in the Tax Code which tend to counterbalance those advantages that we give to single-family housing. We need, in whatever system and whatever changes that this committee decides to pursue, to maintain that balance so that we will be able to effectively compete for capital and keep rents low and as affordable as possible.

Thank you.

[Mr. Driesler's prepared statement follows:]

TESTIMONY PRESENTED
BY
STEPHEN D. DRIESLER

MR. CHAIRMAN, MEMBERS OF THE FINANCE COMMITTEE, MY NAME IS STEPHEN DRIESLER AND I AM EXECUTIVE VICE PRESIDENT OF THE NATIONAL MULTI HOUSING COUNCIL. THE NATIONAL MULTI HOUSING COUNCIL (NMHC) IS A NON-PROFIT ORGANIZATION WITH OVER 5,000 MEMBERS REPRESENTING ALL ASPECTS OF THE MULTIFAMILY HOUSING INDUSTRY. NATIONAL MULTI HOUSING COUNCIL MEMBERS CONSIST OF MANY OF THE NATION'S LARGEST BUILDERS, DEVELOPERS, SYNDICATORS AND MANAGERS OF RENTAL HOUSING. IT IS FAIR TO SAY THAT NMHC'S MEMBERS BUILD, OWN OR OPERATE MORE APARTMENT UNITS THAN ANY OTHER REAL ESTATE GROUP IN THE COUNTRY TODAY. IN ADDITION, OUR MEMBERS PRIMARILY BUILD AND OPERATE RENTAL HOUSING WITHOUT DIRECT GOVERNMENT SUBSIDIES.

I AM HERE TODAY TO TESTIFY AS TO THE IMPACT OF THE FEDERAL TAX SYSTEM ON THE INVESTMENT COMMUNITY IN GENERAL AND ON INVESTMENT IN RENTAL HOUSING IN PARTICULAR.

THE FLOW OF INVESTMENT CAPITAL INTO RENTAL HOUSING IS STRONGLY DEPENDENT UPON INCENTIVES CONTAINED IN THE TAX LAW. WITHOUT THE INCENTIVES NOW IN THE TAX CODE, THE RENTAL HOUSING INDUSTRY WOULD BE UNABLE TO EFFECTIVELY COMPETE IN TODAY'S CAPITAL MARKETS.

THE SIMPLE FACT IS WITH TODAY'S HIGH COST OF LAND, MATERIALS AND MONEY, MARKET RENTS ALONE GENERALLY DO NOT CREATE AN INCOME STREAM WHICH IS COMPETITIVE WITH OTHER TYPES OF INVESTMENTS. ADD TO THIS THE LEVEL OF RISK ASSOCIATED WITH ANY REAL ESTATE VENTURE AND YOU FIND, WE IN THE RENTAL HOUSING INDUSTRY ARE AT A COMPETITIVE DISADVANTAGE COMPARED TO THE RATE OF RETURN AN INVESTOR CAN GET WITH A MONEY MARKET CERTIFICATE OR OTHER LOW OR "NO RISK" FORMS OF INVESTMENTS. THUS, CONGRESS HAS CONSISTENTLY RECOGNIZED THAT TAX INCENTIVES WERE A NECESSARY AND DESIRABLE MEANS OF ENHANCING THE

ATTRACTIVENESS OF INVESTMENT IN RENTAL HOUSING.

WHY WON'T MARKET RENTS SUPPORT THE COST OF RENTAL HOUSING WITHOUT THESE ADDED TAX INCENTIVES?

THE ANSWER TO THIS QUESTION LIES, IN PART, WITH THE MAJOR DISTORTION OF THE HOUSING MARKET TOWARD HOMEOWNERSHIP IN THIS COUNTRY. WE ARE NOT PLAYING ON A LEVEL FIELD WHEN IT COMES TO HOUSING.

THE LARGEST HOUSING SUBSIDY GIVEN BY THE FEDERAL GOVERNMENT IS THE TAX ADVANTAGE OF HOMEOWNERSHIP. THE ABILITY TO DEDUCT MORTGAGE INTEREST AND REAL ESTATE TAXES AS WELL AS DEFER ALMOST INDEFINITELY ANY TAX ON GAIN RECOGNIZED FROM A SALE MAKES HOMEOWNERSHIP THE LARGEST USED TAX SHELTER IN THIS COUNTRY.

IN 1981 THE COST TO THE TREASURY OF TAX SUBSIDIES TO HOMEOWNERS WAS ESTIMATED AT $35 BILLION. WHILE THERE ARE MANY VALID PUBLIC POLICY REASONS TO SUPPORT ALLOWING THESE DEDUCTIONS, AND WE DO NOT SUGGEST THEY SHOULD BE MODIFIED, ONE CANNOT IGNORE THE MAJOR IMPACT THESE TAX INCENTIVES HAVE ON THE RENTAL HOUSING MARKET.

AS SOON AS THE TYPICAL TENANT REACHES THE INCOME LEVEL WHERE THEY CAN AFFORD RENTS HIGH ENOUGH TO SUPPORT NEW CONSTRUCTION, THEY HAVE VERY STRONG TAX REASONS FOR SWITCHING FROM RENTING TO HOMEOWNERSHIP. THUS, THE HIGHER INCOME TENANTS ARE CONSTANTLY SKIMMED OFF THE RENTAL POOL.

THIS IS A MAJOR REASON WHY THE MEDIAN INCOME OF RENTERS HAS STEADILY DECLINED UNTIL DEMOGRAPHICALLY RENTERS ARE MORE AND MORE CONFINED TO THE LOWER ENDS OF THE ECONOMIC SCALE. (ALMOST 48% OF ALL RENTERS HAD INCOMES

BELOW $10,000.) WHILE AT THE SAME TIME MEDIAN INCOME FOR THE GENERAL POPULATION HAS RISEN DRAMATICALLY.

THE ONLY WAY TO PARTIALLY OFF-SET THIS DISADVANTAGE AND TO KEEP RENTS DOWN AND AFFORDABLE IS THROUGH TAX BREAKS GIVEN TO OWNERS AND INVESTORS IN RENTAL HOUSING.

AT A TIME WHEN WE ARE ALL FACING THE NECESSITY OF REDUCING THE FEDERAL DEFICIT WE MUST ALSO LOOK AT THE REALITY OF MEETING THE HOUSING NEEDS OF ALL OUR CITIZENS NOT JUST HOMEOWNERS. WE NEED APARTMENTS AND RENTAL HOUSING TO PROVIDE FOR THE SHELTER NEEDS OF LOW, MODERATE AND MIDDLE INCOME CITIZENS OF THIS NATION WHO CANNOT AFFORD OR DO NOT CHOOSE HOMEOWNERSHIP. THOSE NEEDS ARE NOW STARTING TO BE MET.

MR. CHAIRMAN, THE RENTAL HOUSING INCENTIVES WHICH THIS COMMITTEE PUT INTO LAW ARE WORKING. PRODUCTION IS EXPANDING. PEOPLE ARE ONCE AGAIN EMPLOYED IN BUILDING MULTIFAMILY HOUSING. TIGHT RENTAL MARKETS ARE BEGINNING TO EASE. FOR THE FIRST TIME SINCE THE MID-1970'S, THE PRODUCTION OF UNSUBSIDIZED RENTAL HOUSING IS SHOWING SIGNIFICANT INCREASES. REDUCED INTEREST RATES, PARTICULARLY THOSE AVAILABLE IN THE TAX-EXEMPT MARKET, COMBINED WITH THE TAX INCENTIVES PROVIDED BY ACRS, HAVE MADE RENTAL HOUSING FINANCIALLY FEASIBLE WITHOUT THE NEED FOR DIRECT FEDERAL SUBSIDY. AS A RESULT, WE ARE SEEING THE CRISIS IN RENTAL HOUSING, WHICH WORSENED STEADILY OVER THE PAST SEVERAL YEARS, BEGIN TO ABATE.

HOWEVER, THIS IMPROVED CLIMATE FOR RENTAL HOUSING MAY NOT LAST TOO MUCH LONGER. THE CURRENT CHANGES IN PARTNERSHIP PROVISIONS, ACCOUNTING CHANGES AND ~~TIME VALUE OF~~ MONEY PROPOSALS NOW PENDING BEFORE CONGRESS HAVE ALREADY BEGUN TO CHANGE THE WILLINGNESS OF INVESTORS TO PUT THEIR MONEY INTO RENTAL HOUSING.

WE URGE THE FINANCE COMMITTEE NOT TO FURTHER JEOPARDIZE THE RENTAL HOUSING RECOVERY BY ANY ADDITIONAL CHANGES IN THE TAX CODE.

DURING THE PAST FEW YEARS CONGRESS AND THE ADMINISTRATION HAVE EITHER ELIMINATED OR DRASTICALLY REDUCED FEDERAL RENTAL HOUSING PROGRAMS. THIS IS ESPECIALLY TRUE IN THE AREA OF NEW CONSTRUCTION. THEREFORE, ANY NEW RENTAL HOUSING BUILT IN THIS COUNTRY IN THE FORSEEABLE FUTURE MUST COME FROM THE PRIVATE SECTOR. IF, HOWEVER, THE PRIVATE SECTOR CANNOT ATTRACT SUFFICIENT CAPITAL TO BUILD OR MAINTAIN APARTMENTS, WHO WILL MEET THE HOUSING NEEDS OF AMERICA'S RENTERS? THE ANSWER IS NO ONE.

ASK YOURSELF WHO IS THE ULTIMATE BENEFICIARY OF THE PRESENT TAX ADVANTAGES GIVEN TO RENTAL HOUSING?

THE ANSWER IS THOSE WHO RENT.

THIS POINT WAS CONFIRMED BY A RECENTLY PUBLISHED STUDY BY THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT ENTITLED FEDERAL TAX INCENTIVES AND RENTAL HOUSING WHICH ACCORDING TO SECRETARY PIERCE, "DOCUMENTS THE CLOSE AND SIGNIFICANT RELATIONSHIP BETWEEN FEDERAL TAX AND HOUSING POLICIES".

THIS HUD STUDY FOUND, "GIVEN THE COMPETITIVE NATURE OF THE RENTAL HOUSING MARKET, IT IS LIKELY THAT MOST OF THE BENEFITS OF RENTAL-SPECIFIC TAX PROVISIONS ACCRUE TO RENTERS."

THIS STUDY NOTED THAT THE ACRS SYSTEM ENACTED AS PART OF THE ECONOMIC RECOVERY TAX ACT (ERTA) HAS PRODUCED NET BENEFITS FOR RENTAL HOUSING. IT FURTHER CONCLUDED THE ULTIMATE BENEFICIARY OF THESE TAX ADVANTAGES IS THE CONSUMER. AFTER CAREFUL ANALYSIS OF THE NATURE OF THE RENTAL HOUSING

MARKET, FUND, "IT IS LIKELY THAT MOST OF THE BENEFITS TO OWNERS AND INVESTORS UNDER ERTA WILL ACCRUE TO TENANTS IN THE FORM OF LOWER RENTS THAN WOULD BE THE CASE WITHOUT ERTA."

THIS STUDY WENT ON TO POINT OUT, "OWNERS OF RENTAL PROPERTY MAY BENEFIT BY THEMSELVES IN THE SHORT RUN FROM A FAVORABLE CHANGE IN RENTAL TAX PROVISION. HOWEVER, AN ENHANCED RATE OF RETURN WILL ATTRACT MORE INVESTMENT AND LEAD TO LOWER RENTS THAN WOULD BE OBTAINED IN THE ABSENCE OF THE FAVORABLE CHANGE. SINCE RENTERS HAVE LOWER INCOMES THAN OTHER HOUSEHOLDS, TAX BENEFITS THAT LEAD TO DECREASED RENTS TEND TO BE PROGRESSIVE IN NATURE."

OBVIOUSLY, THE CONVERSE OF THIS FINDING IS EQUALLY TRUE. ANY CHANGES IN THE TAX CODE WHICH WOULD REDUCE THE FLOW OF CAPITAL INTO RENTAL HOUSING OR DRIVE UP ITS COSTS WOULD ULTIMATELY RESULT IN HIGHER RENTS AND SHORTAGES OF AFFORDABLE HOUSING AND WOULD BE REGRESSIVE IN NATURE.

THE ABILITY OF INVESTORS TO RECOVER THEIR CAPITAL FROM REAL ESTATE IN GENERAL AND RENTAL HOUSING IN PARTICULAR IS ESSENTIAL TO THE HEALTH OF OUR NATION'S APARTMENT INDUSTRY.

IT HAS BEEN ARGUED BY SOME THAT REAL ESTATE GOT "TOO MUCH" OUT OF THE 1981 TAX ACT (ERTA). HOWEVER, INVESTMENT IN STRUCTURES CAME OUT OF ERTA AT A COMPARATIVE DISADVANTAGE COMPARED TO INVESTMENT IN OTHER TYPES OF ASSETS.

THIS WAS DOCUMENTED BY A 1981 STUDY DONE FOR THE LIBRARY OF CONGRESS BY JANE GRAVELLE ENTITLED, "EFFECTS OF THE ACCELERATED COST RECOVERY SYSTEM BY ASSET TYPE".

THE FINDINGS OF THIS STUDY WERE THAT ACRS WOULD TEND TO SHIFT "THE COMPOSITION OF CAPITAL TOWARDS BUSINESS EQUIPMENT AND AWAY FROM STRUCTURES, PARTICULARLY AWAY FROM RESIDENTIAL STRUCTURES". THE RELATIVE (AND PERHAPS ABSOLUTE) SIZE OF THE HOUSING STOCK COULD FALL, NOT ONLY BECAUSE OF THE EFFECTS ON RENTAL HOUSING, BUT ALSO BECAUSE HIGHER INTEREST RATES WILL MAKE OWNER OCCUPIED HOUSING LESS ATTRACTIVE AND BECAUSE THERE ARE NO OFFSETTING TAX BENEFITS.

IN SUMMARY, RENTAL HOUSING'S ABILITY TO COMPETE IN THE CAPITAL MARKET IS VERY DEPENDENT ON CAREFULLY CONCEIVED AND LONG STANDING PROVISIONS IN THE FEDERAL TAX CODE. THESE PROVISIONS INCLUDE THE:

A) EXEMPTION FROM THE AT RISK RULE:

B) AN ACCELERATED COST RECOVERY SYSTEM (ACRS) WITHOUT FULL RECAPTURE; AND

C) THE ABILITY TO PASS THESE ADVANTAGES ON TO INVESTORS THROUGH LIMITED PARTNERSHIP VEHICLES.

IF ANY OF THESE TAX ADVANTAGES ARE ELIMINATED OR EVEN DECREASED SUBSTANTIALLY OR IF FURTHER RESTRICTIONS ARE PLACED ON PARTNERSHIPS WHICH SEVERELY RESTRICT THE ABILITY TO PASS THE BENEFITS OF THESE TAX PROVISIONS TO INVESTORS THEN RENTAL HOUSING WILL NOT BE ABLE TO EFFECTIVELY COMPETE FOR CAPITAL.

THERE WILL BE TRAGIC CONSEQUENCES IF THIS HAPPENS. ALMOST 48% OF ALL RENTERS HAD INCOMES BELOW $10,000. THESE ARE THE PEOPLE AND FAMILIES WHO WILL BE MOST EFFECTED BY THE INCREASED RENTS AND SHORTAGES OF AFFORDABLE HOUSING WHICH WOULD SURELY RESULT FROM FURTHER CHANGES IN THE TAX LAW IN THESE AREAS.

TAX INCENTIVES FOR RENTAL HOUSING ARE A UNIQUE COMBINATION OF CAPITAL INCENTIVES AND CREATIVE LOW COST PUBLIC POLICY. CHANGES IN THESE INCENTIVES WOULD SERIOUSLY IMPACT THE QUALITY OF LIFE FOR MILLIONS OF AMERICAN RENTERS.

Senator GRASSLEY. Thank you.
Mr. Bryant?

STATEMENT OF JAMES P. BRYANT, VICE PRESIDENT, DIRECTOR OF TAXES, J.C. PENNEY CO., INC., NEW YORK, NY

Mr. BRYANT. Thank you, Senator.

My name is Jim Bryant. I am vice president and director of corporate taxes for the J.C. Penney Co., headquartered in New York.

I am presenting this testimony on behalf of the Retail Tax Committee of Common Interest, which is composed of 11 major retail companies and 2 industry associations, listed in the appendix attached to my statement.

Retailing is a large and growing part of the national economy. Based on first-quarter statistics, 1984 retail sales will exceed $1.1 trillion.

Retailing accounts for almost 17 million employed persons nationwide. An efficient retail sector keeps down the cost of products, exerting a strong pullthrough demand for manufactured goods, and so stimulating production.

Conversely, an inefficient retail sector would add significantly to the final cost of the manufactured goods, thereby fueling inflation and depressing demand, thus impairing the productivity gains achieved in the manufacturing sector.

Given the crucial role that retailing plays in the economy, its treatment under Federal tax law is extremely harsh. Of greater significance is the failure to extend the investment tax credit to retail buildings, which are our largest fixed capital cost. Even single-purpose agricultural or horticultural structures, which include greenhouses, mushroom buildings, and livestock buildings, are eligible for the credit. But retail buildings, the construction and operation of which provide significant employment, are not eligible.

Depreciation rules have not benefitted retailing, either. From 1962 until 1981, allowable depreciation on retail structures was steadily restricted. At the same time, allowable depreciation on machinery and equipment was steadily liberalized, which benefitted retailers much less than manufacturers.

In 1981, the accelerated cost recovery system provided a 15-year, 175-percent declining balance depreciation category for all buildings. This improved both the rate of depreciation and its simplicity. Yet, today the congressional conference committee that is considering the 1984 tax bill has before it a Senate amendment to replace the 15-year category with a 20-year category, phasing down to 18 years in 1986, allegedly to deal with tax-motivated churning of buildings.

Two points have been largely overlooked by policymakers during the debate over the 15-year category. First, ACRS has not improved the historical treatment buildings receive relative to machinery and equipment. The relationship between the 15-year category for buildings and the 3- and 5-year categories for vehicles and equipment still impose much higher rates of tax on income generated by productive buildings.

Second, changing the ACRS category will not eliminate tax-motivated real estate churning. Retailers who do not buy and sell buildings for tax benefits but who use them as equipment should not be stripped of part of the modest benefit of ACRS as part of an effort to correct a situation in which we do not participate.

As an industry, retailing has paid high effective rates as compared to most manufacturing and financial sectors, historically in excess of 30 percent. This information has been overshadowed by press accounts and congressional speeches about low effective tax rates documented in the same studies, but the facts are still there.

Considerable attention is now being given to fundamental tax reforms and alternative tax systems by Federal policymakers. However, there are many observers who argue that this process will become intertwined with revenue raising in 1985 and 1986. One approach to this would be to impose a surtax during a temporary or transitional period for an alternative system. The surtax is not equitable. The surtax would impose the heaviest burden on retailing and other firms that already pay the highest effective tax rates, while falling much less heavily, if at all, on equally profitable firms that utilize an array of deductions, exemptions, and credits to reduce or eliminate taxable income and/or tax liability.

In conclusion, as Congress and the administration undertake studies of reforms and alternative systems, existing burdens need to be recognized. Furthermore, temporary or transitional revenue-raising measures such as surtaxes must be avoided.

Thank you very much, Senator.

[Mr. Bryant's prepared statement follows:]

DRAFT

June 15, 1984

TESTIMONY OF

JAMES P. BRYANT

VICE PRESIDENT AND DIRECTOR OF CORPORATE TAXES

J. C. PENNEY COMPANY, INC.

ON BEHALF OF

THE RETAIL TAX COMMITTEE OF COMMON INTEREST

BEFORE

THE SUBCOMMITTEE ON OVERSIGHT OF
THE INTERNAL REVENUE SERVICE

COMMITTEE ON FINANCE

UNITED STATES SENATE

June 18, 1984

* * * * * *

My name is James P. Bryant, and I am Vice President and Director of Corporate Taxes for J. C. Penney Company, Inc., headquartered in New York. I am presenting this testimony on behalf of the Retail Tax Committee of Common Interest, which is composed of eleven major retailing companies and two industry associations. A list of the members is attached as the Appendix to my statement.

The Committee was formed in 1977 to enable its members to focus intense attention on tax policies and procedures that are of general concern to the industry. We appreciate the Subcommittee's interest in studying the impact of existing tax law on various sectors of the economy, and we welcome this opportunity to present the retailing industry's views to you.

My statement sets forth the following points:

(1) The significance of a modern and efficient retailing sector to the U.S. economy is often overlooked by press and policymakers who tend to focus attention on high technology and/or basic industry issues;

(2) Retailing historically has paid relatively high effective rates of federal tax, since the industry in general benefits only modestly from the long list of exemptions, deductions and credits that have become fixtures of the Internal Revenue Code;

(3) Even the 1981 tax reductions were of limited benefit to the industry, in comparison to its impact on other sectors; and

(4) Consideration of both near and long-term tax alternatives or tax increases should not include any proposals -- such as surtaxes and variations thereof -- that increase the already high effective rates paid by the industry.

I. The Significance Of Retailing To The Economy And The Consumer

Retailing is a large and growing part of the national economy. Based on first quarter statistics, 1984 retail sales will exceed $1.1 trillion dollars while total GNP will exceed $3.5 billion. In terms of employment, retailing accounts for one out of every 7 workers throughout the nation -- almost 17 million persons -- in over 1.8 million retail establishments. Retail trade also is one of the fastest growing employers. From 1978 to 1983, retail employment increased more than 50 percent faster than total employment, up 6.3% as compared to 4% for the economy as a whole.

Retailing is thus a large and important force in the economy. But its importance does not lie solely in its size, or in its contribution to the GNP, or in the extent to which it provides jobs, significant as these measurements may be. Rather, retailing's importance is structural, and lies in the role it plays in bringing goods from producer to consumer. The retail function is essentially a distributional function. Like transportation and wholesale-distribution, retailing's place in the economy lies between production and consumption, linking the two together. But because retailing does not, except incidentally, physically transport goods from one place to another, its function and the value it adds to consumer goods are often not fully appreciated.

The economic value retailing provides is substantial. In the first instance, it is the retailer, by placing the order with the manufacturer, who causes goods to be brought from the place of origin to the market where they ultimately will be consumed. The retailer constructs the store, staffs it with employees, orders and pays for and stocks the goods -- all before the consumer is even aware that many products are even available. After bringing the goods to market, the retailer displays them along with other, similar goods to facilitate the consumer's comparison and choice, and offers them for sale at times when and at locations where those goods are accessible and convenient to the ultimate buyer.

Thus, the retailer adds economic value to consumer goods just the same as does the manufacturer when he creates them out of raw materials or does the railroad or trucking company when it transports them. For example, the value of a dress in a loft in New York's garment center, or of a chest of drawers in a warehouse in the Carolinas, is much less to a potential consumer in, say, New Orleans than the same dress or chest of drawers when it is on display at a downtown store or suburban shopping center just a short distance from his home or office. The retailer performs these value-adding functions because he can do so more efficiently than can any individual consumer. The retailer thus adds value to consumer goods by bringing goods to the consumer when and where the consumer wants them, and in sufficient variety to facilitate an informed choice, and in sufficient quantity to obtain reasonable prices from manufacturers.

This is the sense in which the retailer stands in an economically pivotal position, between the two ends of the economy. It is the retailer that provides the path along which goods flow from the manufacturer to the consumer in a cost-effective and energy-efficient manner. An efficient retail sector keeps down the final cost of a product, exerting a strong "pull-through" demand for manufactured goods and so stimulating production. Conversely, an inefficient retail sector would add significantly to the final cost of manufactured goods, thereby fueling inflation and depressing demand, thus vitiating the productivity gains achieved in the manufacturing sector.

II. The Treatment Of Retailing Under Federal Tax Law

Given the crucial role that retailing plays in the economy, its treatment under federal tax laws is extraordinarily harsh. In fact, the industry's effective tax rates have been relatively high in comparison to most of the manufacturing and financial sectors of the economy.

A. Income Tax Issues

Even though retailing is highly labor-intensive and commits much of the industry's scarce capital to intangibles, retailers also have large fixed capital costs. The largest such fixed capital cost is the retail structure itself -- the store. Federal tax law cannot be accused of having treated this capital asset with any kind of favoritism. Indeed, such physical assets seem to have been singled out for intentional penalities.

1. Investment tax credit. Certain "other tangible property" (as defined in Internal Revenue the Code) used in manufacturing, mining, communications, transportation and utilities qualifies for the investment tax credit (ITC) but such property does not qualify if it is used in retailing. For example, paved parking areas at a store or shopping center are not eligible for the tax credit. In contrast, if located at a manufacturing facility, paved parking areas generally would be eligible. Similarly, air conditioning systems to maintain temperature and humidity in manufacturing plants qualify, but air conditioning systems in retail stores do not qualify.

Of greatest significance is the failure to extend the ITC to retail buildings (i.e., stores, warehouses and related retail facilities). Capital investment in fixtures, machinery and equipment qualifies for the credit. Even "single purpose agricultural or horticultural structures," which includes greenhouses and mushroom buildings and livestock buildings, are eligible for the credit. But retail buildings, the construction and operation of which provide significant employment, are not eligible. Only when a very old or historic building is rehabilitated can a retailer utilize a special credit with respect to the building itself. In contrast to other industries, retailers normally have a relatively larger investment in retail buildings than in fixtures, machinery and equipment. As a result, the tax laws as presently structured inordinately favor industries which invest in equipment and machinery.

2. Depreciation. Depreciation rules have not benefitted retail buildings either. When the ITC was enacted in 1962, retail and other structures were thought to enjoy favorable depreciation rules. At that time, retail structures could be depreciated under the 200% declining balance method, and depreciation deductions on structures were not subject to "recapture," when the building was sold. Also, the depreciable lives then permitted for structures were perceived by many to be liberal. From 1962 until 1981, allowable depreciation on retail structures was steadily restricted. At the same time, allowable depreciation on machinery and equipment was steadily liberalized, which benefitted retailers much less than manufacturers.

In 1964, section 1250 was enacted to recapture, upon disposition of a structure, the excess of accelerated depreciation over straightline depreciation. Although not important to retailers, this change was a signal that policymakers did not distinguish between those who use buildings as "equipment" in their businesses and those who use them as speculative or inventory assets. Then, section 1250 was made more stringent by further amendment in 1969. Also in 1969, depreciation on retail structures was reduced to the 150 percent declining balance mode.

Furthermore, retail structures were excluded from the shortening of depreciable lives for machinery and equipment which occurred in 1962 with the introduction of guideline depreciation in Revenue Procedure 62-21 and which occurred again in 1971 with the enactment of the Asset Depreciation Range system.

In 1981, the Accelerated Cost Recovery System (ACRS) provided a 15-year/175% declining balance depreciation category for all buildings. This improved both the rate of depreciation and the simplicity of depreciation for retail structures. Yet, the new statute was less than one year old before the 15-year category was subject to attack as being too generous and as encouraging "churning" of buildings for tax shelter purposes. Today, the Congressional Conference Committee that is considering the 1984 tax bill has before it a Senate amendment to eliminate the 15-year category and to replace it with a 20-year category, phasing down to 18 years in 1986.

Two points have been largely overlooked by policymakers during the debate over the 15-year category. First, ACRS has not improved the historical treatment buildings relative to machinery and equipment. The relationship between the 15-year category for buildings and the 3- and 5-year categories for vehicles and equipment still impose much higher rates of tax on income generated by productive buildings. Second, changing the ACRS category will not eliminate tax-motivated real estate "churning." If that activity truly is a problem, it should be addressed by imposing full recapture on depreciation deductions when a building is sold, rather than allowing investors to convert ordinary income into capital gain upon the sale. Retailers who do not buy and sell buildings for tax benefits, but who use them as equipment, should not be stripped of part of the modest benefit of ACRS as part of an effort to correct a situation in which we do not participate.

III. High Effective Tax Rates

As an industry, retailing historically has paid high effective rates of tax compared to most manufacturing and financial sectors. The two principal annual studies of effective corporate income tax rates (prepared by the staff of the Joint Committee on Taxation and by the weekly publication TAX NOTES) have shown the predominantly retailing companies to be paying effective tax rates well in excess of 30%. This information has been overshadowed by press accounts and Congressional speeches about low effective rates documented in the same studies, but the facts are still there.

A McKinsey and Company study in 1983 for the American Business Conference, which included data from 1977 through 1981 for mid-sized as well as large retailers indicates effective corporate tax rates of 32.3% and 35.2% respectively for these groups for the 5-year period.

The fact that the industry pays relatively high effective income tax rates is not surprising when one considers how little benefit the industry receives from the major business features of the Code, such as the ITC and ACRS. The absence of significant provisions such as tax-exempt income, deductions for intangibles, and deductions for financial reserves also contribute to keeping retailing's rates high.

IV. Surtaxes and Long-term Tax Restructuring

A. Tax Reforms and Alternatives

Considerable attention is being given to fundamental tax reforms and alternative tax systems by federal policymakers, by interested taxpayers and organizations, and by the press. Congressional hearings and the Treasury Department's hearings around the country this month attest to the importance being placed on the tax reform and tax alternatives issues.

The discussion and debate that have already begun to flow from the work now being undertaken by many groups can be very informative and enlightening for both the public and federal policymakers. The minimum benefit to be derived from all of this activity should be a significantly enhanced understanding of the impact that various tax systems do or can have on a wide range of economic activities. If we are fortunate, perhaps this process will actually produce a new, reformed, simplified and/or otherwise improved structure for generating federal revenues.

But whatever the outcome, this process is too potentially important for the future of our society and our economy to be undertaken without a thorough understanding of the problems generated by the present system, because the cumulative effects of these problems have been a primary cause of the widespread support for the current initiatives. In other words, we must not become so fascinated by the crafting of new systems that we fail to correct -- or we actually worsen -- the circumstances which we set out to address. One such problem is the wide disparity in effective tax rates paid by business entities under current law, as discussed above.

B. Linking Restructuring To Revenue Raising

Another potential problem area is the relationship of revenue raising to tax restructuring. As we understand it, the primary purpose of various alternative tax systems introduced in Congress and of the Treasury's current study is to assess fundamental tax reforms and alternative tax systems; increasing revenues is not the objective.

However, there are many observers who argue that these two objectives will become intertwined in 1985 and 1986. Therefore, we are taking this opportunity to emphasize one important -- but often ignored -- economic and financial fact:

> A surtax or any related mechanism would be the most objectionable and least equitable means for increasing taxes. By definition, it would fall heavily on retailing and others who already pay the highest rates while barely impacting those who already pay very little.

A surtax would be a step backward in tax policy development. The income tax has developed its numerous exemptions, deductions and credits in large part as a result of taxpayers' intense desire to find relief from high nominal tax rates. To increase those rates through a surtax would only stimulate the already well-developed capabilities of various groups to seek relief. What is needed now is a significant reduction in such stimulation.

This concern is not merely theoretical. There are real, practical possibilities under which a surtax could be combined with long-term restructuring proposals that will be seriously considered in the coming months. Certain new tax systems such as the "consumable income" varieties would require significant transitional rules before becoming fully effective. A surtax can become a very tempting device for raising revenues while the old system is being phased out by a new one.

Unfortunately, one such package has already been unveiled. The recently released Brookings Institution book, Economic Choices 1984, makes just such a proposal. Chapter 5, entitled "Reforming the Tax System," suggests the following as a shortrun program while long-term restructuring is underway:

> Such a program of short-run base broadening could go a long way toward meeting the revenue goals set forth in this book, but it is highly unlikely that a consensus on these matters can be achieved very quickly. We therefore urge enactment of a surtax that when added to the revenues provided by short-run base-broadening reforms would assure that the revenue goals ... are met. If half the short-run base-broadening goals were enacted, they would meet the revenue goals for 1985 with only a 2 percent surcharge. If none were enacted, a surcharge of 6 percent would be necessary to meet these goals. By 1989, however, the tax increase required to meet these targets is so large--$108 billion-- that to reach them would require either a surcharge of 19 percent or enactment of half the base-broadening measures plus a 10.5 percent surcharge on personal and corporation incomes.
>
> Any surcharge would raise rates levied on a still-distorted tax base and aggravate the distortion between fully taxed activities and partially taxed or exempt activities. Only the overriding need for reducing the deficit would justify these added distortions, even on a temporary basis. A surcharge would stand out from the fundamental tax structure, underscoring its temporary nature, and would emphasize that work on long-run base broadening must begin immediately. (Emphasis added)
>
> Pages 90-92

Regrettably, the proposal calls for precisely the wrong approach, both economically and as a matter of legislative tactics. The "short-run base-broadening" initiatives include repeal or limitation of several of the features of present law that contribute to disparities in rates. But coupling these restrictions with a "temporary" surtax, particularly by proposing to increase the surtax percentage if reforms are not accomplished, offers double encouragement for beneficiaries of existing law to oppose the reforms. First, if reforms are defeated or watered down, their relatively low effective rates will be changed very little. Second, the higher tax burden then falls on retailing and other businesses which must bear the surtax, thereby reducing longer-term revenue-raising pressures. Rather than contributing to a reasonable solution to the inequities of high effective rates, this approach could make it worse.

C. Inequities of a Surtax

A surtax is often presented as a simple and equitable means for increasing taxes on business because it can apply uniformly to all business taxpayers. This view is probably rooted primarily in the belief that businesses -- or at least major corporations -- all pay low effective rates of tax and therefore would be rather evenly impacted by a surtax.

But a surtax is not uniformly applicable, for the simple reason that all businesses do not pay the same or even similar effective tax rates, as has been outlined above. In fact, a surtax would impose the heaviest burden on retailing and other firms that already pay the highest effective tax rates while falling much less heavily -- if at all -- on equally profitable firms that utilize an array of deductions, exemptions and credits to reduce or eliminate taxable income and/or tax liability.

Although oversimplified, the following three examples illustrate this point.

VARYING EFFECTS OF A PURE SURTAX

Corporate Tax Computation	Company A	Company B	Company C
Net financial income	$1,000	$1,000	$1,000
Less tax adjustments for			
o ACRS, depletion, loss reserves, etc.	(700)	(100)	(100)
o exempt income	0	(500)	0
Taxable income	300	400	900
Tax at 46% rate	138	184	414
Less investment tax credit (ITC)	(100)	(15)	(15)
Tax paid	$ 38	$ 169	$ 399
Effective tax rate	$ 3.8	$ 16.9	$ 39.9
10% surtax on tax paid	$ 3.8	$ 6.9	$ 39.9
Total effective rate (regular & surtax)	4.2%	18.6%	43.9%

Although starting with identical financial incomes, the three hypothetical firms are treated much differently for tax purposes. The issue is not whether any specific deduction, exemption or credit -- or any industry-wide grouping of such provisions -- is excessive. The retailing industry is not suggesting that any specific tax provision be changed as a means of raising someone else's taxes. Our objective is to reduce the high effective rates that our members pay. Repeal of most of the provisions that benefit low effective rate taxpayers would also increase taxes somewhat for our members because virtually all businesses utilize one or more of these provisions to some extent.

Rather, the issue that we raise for consideration is the fact that a surtax intensifies the assymmetries in effective tax rates because it falls heavily on those companies and industries that are able to realize only a modest benefit from all existing tax provisions, such as Company C, while falling very lightly on those who already realize massive tax benefits.

IV. Conclusion

Over the years, the Internal Revenue Code has been substantially revised by the addition of exemptions, deductions and credits that seek to address a variety of social or economic issues. They may all have been fully justified and may achieve their intended purpose.

But an unintended effect has been to impose discriminatory levels of taxation on retailing which has not benefitted to a significant degree from the current Code. As the tax base was eroded, nominal rates have remained high in order to produce certain levels of revenue. Our industry generally has borne the burden of those rates.

As Congress and the Administration undertake studies of reforms and alternative systems, existing burdens need to be recognized. Furthermore, "temporary" or "transitional" revenue raising measures such as surtaxes must be avoided.

APPENDIX

MEMBERS OF THE RETAIL TAX COMMITTEE OF COMMON INTEREST

Allied Stores Corporation

Associated Dry Goods Corporation

BATUS Retail Division

Carson Pirie Scott & Company

Carter Hawley Hale Stores, Inc.

The Dayton Hudson Corporation

Federated Department Stores, Inc.

R. H. Macy & Company, Inc.

The May Department Stores Company

J.C. Penney Company, Inc.

Sears, Roebuck and Company

American Retail Federation

National Retail Merchants Association

Senator GRASSLEY. I think one or two people who testified, as I recall, on this panel suggested that a neutral Tax Code is something that is very elusive and can't be accomplished.

For those of you who didn't express that opinion, I would like to ask if you would agree with those who have already taken that position, or if you have contrary opinions, state it.

Let's start over here.

Mr. HUNT. I am not sure I understand exactly what you mean by "neutral."

Senator GRASSLEY. Well, where decisions are made on the economic viability of the investment or the expenditure, as opposed to having the Tax Code be the determinant in making the investment or expenditure.

Mr. HUNT. I think the problem our people find is that they are willing to live with almost anything, and they realize the Government needs the money to run, et cetera, et cetera, but what they really hate is what almost everyone here today has said—the churning, the constant churning of regulations and laws, the lack of regulations.

One of the other points which came up, with this hearing in mind, when we had one of our conventions here, I took the point of asking our members, "What do you want?" because I knew you would ask the question. And one of the points which came up was that the Federal Government does have quite a track record on the flat tax already. We know how the Federal Government will react, and we know how people will react. We have the social security tax, which is essentially a flat tax. And I think from what I heard over and over again, the people said "The flat tax sounds wonderful—pie in the sky and everything's fine." And if you did it, obviously in our case for employee benefits, for example, you would also eliminate—as well as any tax advantage for the private ones—you would fully tax the housing subsidy for military dependents; you would do away with the Veterans' Administration. You would probably do away with social security, so let people go out there and suffer on their own. That's one thing, and of course Government is not going to let that happen.

The other concept was, "That's fine; we save 5 percent, 10 percent, and 15 percent," whatever percent it may be this year. The Government does not have a very good track record for being consistent. What is to keep it in 5 years from suddenly being double again and costing much, much more? So I think that is one of the problems we face in the tax system.

I find our people are caught in the middle because we have a very complex system for a complex society. Someone today made the lovely statement, "The more you try to be fair, the more complex it is." And I think that is very true. The flat tax is certainly a very appealing idea, if it will work. I don't think it is practical.

But I don't know that there is an answer. The Government and the IRS, being probably the point man in this, has to establish clear policies. I think a lot of these problems—the tax decisions, for instance—a lot of them are made blindly now. People would probably prefer to make them without that in mind. But the way the operation is now, and frankly the way the administration is—as you have heard, and we find it is very true, too—the field agents just haven't the damndest idea what is going on down here on Constitution Avenue.

And this is the problem you run into: you end up constantly playing bumper pool with the rules.

Senator **Grassley**. Mr. Bryant?

Mr. **Bryant**. Thank you.

I think everyone wants to see a fair tax system. I question in our society whether we can ever achieve that. We have to try to strive to get as close to that as possible.

I don't think the answer is to bring in a complete new system such as a value-added tax or a sales tax, or whatever we want to call it. If those people proposing this think that a national sales tax is going to be a very simple thing—you just pass a rate and everybody pays it—I don't think there are too many people in our society that have as much experience in collecting sales taxes as the retailer, and believe me, it is not that simple, and I cannot see the wisdom of scrapping a system that has been proven. It has its problems—it has been inundated with special-interest provisions—but I think with a dedicated Congress determined to make our system as fair and as equitable as possible we can save the present system.

I do not support a consumption tax; I think we are passing the burden over, then, to the consumer, and we are infringing on let's say the turf of the States, who have a need to raise revenue, and this has been their source for years. And I don't think we should lay a Federal burden off on the States.

I think that we should try to save the system that we have and I think it is doable.

Thank you.

Senator **Grassley**. Mr. Seaman.

Mr. **Seaman**. Senator, I was a carpenter for many, many years and then went into business for myself. I finally retired in 1972 and went back to work for this outfit in 1975. I never have understood our tax system, but every time I questioned an accountant of mine on why he did what he did, I was very impressed with the fairness of his logic and of the IRS's logic.

Now, since I am not involved day to day in business anymore, I have to listen to what business people say. And the message that this gentleman down at the end has got is unconscionable.

We could possibly come up with a flexible spending account that could reduce medical costs in this country by untold billions of dollars by simply rewarding a low-salaried person—I mean, that's a sensible, logical thing. And for the IRS to step out in the newspaper and try to demolish that is unconscionable.

I feel that the tax rules recently—it just depends on whose ox is getting gored. I am up here talking about the insurance industry being treated as fairly as they are, because of the changing technology that makes this eminently possible and fair to all concerned. Previous to this time it was not fair, and it was not asked for.

The other thing I caution you about is that I spent a weekend with two of my daughters—one married. And I asked them. They don't understand the system, and they want that flat tax, because they are convinced that other people are not paying, and some people are not paying at all legally. They don't understand that; they are incensed about it, they are outraged, they are mad. And I raised pretty straight-thinking children, and I was surprised to hear these 20- and 30-year old people talking as vehemently about a problem as this is. I just want to put that out there.

Senator GRASSLEY. It seems to me that that is an everyday reaction by middle income taxpayers, people with $20,000 to $40,000 incomes. I think that that is a fair reaction. And that is something that this committee has to deal with, regardless of the productivity question, because we have a fairly successful tax system because of voluntary compliance, and with tax revolts and the underground economy growing, those are I think some very real example of people have a lack of credibility in the system, see, and consequently, an issue that we have to deal with in order to keep the voluntary compliance.

If we didn't have voluntary compliance, I don't think we would have a big enough army to enforce it. So the voluntary compliance has to be a major goal of any tax policies we make, and we have been losing ground with that.

So, to some respect, a simplification of the tax system I think addresses that to some extent—not totally. But in the process of doing that you don't want to create an economic environment where productivity is hindered. And I don't know whether we have enough evidence yet to say that the complicated tax system we have has hindered productivity; that is what the purpose of these hearings is, to address that issue. There is always going to be some trade-off.

Mr. Piliero, I think you are the one that instigated my question. Did you have anything in addition that you wanted to say?

Mr. PILIERO. Yes; I would like to react to your last point, Senator, which is the issue of public protection of our existing tax system, which is so important.

In 1972, as you know, Senator, TEFRA passed with a 20-percent floor. The alternative minimum tax—and your daughters might be interested to know this—guarantees that no American can pay less than 20 percent. So a flat tax of a sort—if you will, a minimum alternative flat tax—is in. You can have all the tax shelters in the world that you want, but you are going to pay a 20-percent tax. That is there.

Senator GRASSLEY. I don't think the public is reminded of that often enough. It is not central to their thinking.

Mr. PILIERO. That's right.

Senator GRASSLEY. And, hence, they feel that there are people who aren't paying tax.

Mr. PILIERO. And that is not so, after 1982.

Senator GRASSLEY. You still might find a few hundred people—I think I have seen some statistics in recent years, because we have tried to deal a little bit with follow-ons of the minimum tax that we have passed in four or five tax bills since then—who try to plug even further those loopholes.

Mr. PILIERO. That is correct; but, essentially——

Senator GRASSLEY. Essentially, you are correct.

Mr. PILIERO. We are dealing with no American not paying taxes; we are dealing with every American paying a minimum of 20 percent.

Senator GRASSLEY. Yes.

Mr. PILIERO. In the areas of investment with which we are most concerned, oil and gas exploration, you could put your money in the bank and get a 10-percent return, or you could put your money into oil and gas exploration and if you lose it you will get certain write-offs. We think it is in the benefit of our national interest to encourage oil and gas exploration.

Life insurance payments? We are talking now about taxing the inside buildup on life insurance policies, whole life. That, in my judgment, would be very wrong. It would take away the long money which has been used for development of capital and equipment. Those long-term loans come out of life insurance policies which will not continue if the inside buildup is taxed.

So, the flat-rate tax proposals, the so-called broadening of the base, in our judgment is unwise, the elimination of certain key deductions which are aimed at energy, aimed at developing long-term capital—it is easy to say with a flat-rate tax "let's just take out a calculator and we'll know just how much you owe." It is a lot more difficult to administer a very complex country. We do not think the flat-rate tax is the answer.

Senator GRASSLEY. Do you have anything to add, Mr. Driesler?

Mr. DRIESLER. Two quick points, Mr. Chairman.

First—again, to echo what a number of the panelists have already said—while the concept of a pure flat-rate tax has a great deal of political appeal, and we all recognize that, in our own specific example at least all of the major proposals that I have seen before the Congress maintain the exemption for single-family home interest, it maintains the exemption for the real estate property tax. That distorts the market within the housing area. There are other examples that the people on this panel have pointed out.

So you are still having the distortions that will require, as Mr. Alexander pointed out, you know, "Once A has it, then B wants it, then C wants it." If you are going to go all the way, then go all the way.

The second point is that we have talked a lot about tax simplification, and I don't know that simplification is really what we ought to be looking at, because simplification is not necessarily more fair, simplification is not necessarily better—simplification is just simply simpler. And simplicity for its own sake, as a number of people here have pointed out, is not necessarily what is needed in this society, because we are not in a simple society.

Senator GRASSLEY. Yes, sir?

Mr. HUNT. Senator, one point which I think several people have brought up—and I was hoping somebody else would be more discreet in saying it; I tend to be a little bit too candid—I think a lot of the problems which have come up in all of the hearings you have had previously and then on all of the panels today is that the planning should be done with people like ourselves ahead of time, and not just being done by theoreticians—be it the Joint Committee on Taxation, or whatever. So often we find that a bill is popped on us, or a regulation is popped on us, and we have to respond to that, rather than sitting down and discussing it.

I have often said, for the regulations where it is fairly simple, why not have the hearings ahead of time and then come up with the regulation, rather than vice versa, which is an important point of what you are saying.

Also, as Mr. Piliero said, I happen to know that for employee benefits between a fourth and a third of the total investment capital in this country comes from employee benefits, which I think he was saying. And this is very carefully monitored by the Department of Labor. So this is a very positive point in the investment industry and probably the largest single source in the investment industry. It is not a sinister source, because it is so carefully monitored.

Senator GRASSLEY. Yes, sir?

Mr. SEAMAN. Senator, you inquired of previous speakers as to the influence the Tax Code had on business people's actions.

I would say that any time they are considering making a move, the first thing they do is to resolve the tax implications—positive or negative. "If it is positive, we will move ahead; if it's negative, we won't." Every action.

If you change something to do with employee benefits, if those benefits are no longer deductible, "We'll no longer pay the benefit."

If you say that buildings are not going to have any depreciation included with them, "We'll put up a tent or a bubble; we'll do something," if there is a viable alternative.

Our first consideration is the tax, because if we don't figure it out our competitor is going to, and when he does he will whip us in the marketplace.

Senator GRASSLEY. I want to say thanks to each of you. And as we review the testimony we have just had, my staff and I will sit down and decide if there are any followup questions. We will do that quickly. If there are, we would appreciate answers in writing within 15 days. Thank you very much. The hearing is adjourned.

[Whereupon, at 12:27 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

June 18, 1984

Statement of Coalition of Service Industries (CSI)

Before Senator Grassley's Subcommittee

The chief point that CSI would like to make today is best summed up in that old adage "The only thing worse than paying taxes is paying more than your neighbor". Multisector equity and activity-specific equity are CSI's tax goals.

CSI represents a broad coalition of service companies. Our purpose is to educate Congress and the public on the importance of services in the U.S. and world economy and to insure that the interests of our members are duly recognized in legislation that affects the economy. In the past, I am sure you will appreciate, services have been overlooked, and at times even discriminated against.

Service companies pay a higher than average effective tax rate. They are paying more than their fair share of America's corporate tax burden. There is simply no justification for this - political, economic or social - and it penalizes the most dynamic and job-intensive part of the economy.

The major reason for this inequity is that when Congress distributes benefits to America's businesses, it ignores most service industries in favor of traditional, politically-entrenched sectors. Thus, DISC benefits are extended only to exporters of goods not services. The R&D credit is only for laboratory-type research although increasing productivity in services is as much in the national interest as increasing productivity in manufacturing and pharmaceuticals. ACRS and the ITC favor heavy equipment and industrial concerns. In fact, when the Economic Recovery Tax Act was passed in 1981, although it was billed as the principal driving force for the economic revitalization of America, no incentives were awarded to service companies.

The popular notion of the level playing field is also of great concern to service companies. For example, does it seem fair or otherwise make sense that a bank, insurance company and insurance agency be subject to different tax regimes even though many of their products are identical? It seems to us that anyone engaging in a particular economic activity should receive the same tax treatment for that activity.

Democracy in America began with a tax revolt. If Democracy means anything, benefits should accrue to the many not the few. Today's tax system penalizes service businesses, which are the majority. How long does Congress intend to perpetuate this inequity? CSI favors a comprehensive overhaul of our corporate tax system to achieve equity among business sectors and in respect of each economic activity.

[illegible] Jun 18 Rec

Chairman, George A. Strichman, Chairman of the Board, Colt Industries Inc

Vice Chairman (at large), Donald P. Kelly, President, Esmark, Inc

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Vice Chairman (Machinery), David C. Garfield, President, Ingersoll-Rand Company

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**COMMITTEE
FOR
EFFECTIVE
CAPITAL
RECOVERY**

*(formerly
Ad Hoc Committee
For An Effective
Investment Tax Credit)*

STATEMENT OF

GEORGE A. STRICHMAN
CHAIRMAN OF THE BOARD
COLT INDUSTRIES INC

ON BEHALF OF THE

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

SUBMITTED TO

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

SENATE FINANCE COMMITTEE

UNITED STATES SENATE

HEARING ON IMPACT OF TAX SYSTEM ON PRODUCTIVITY

June 18, 1984

1901 L Street, NW, Suite 303, Washington, D.C. 20036 (202) 223-3293

INTRODUCTION

The Committee for Effective Capital Recovery is a volunteer coalition of over 600 business firms and more than 50 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation and utilities. A list of the member companies and supporting associations is attached (see Appendix A).

The Committee has long been active in efforts to improve, strengthen and make permanent, capital cost recovery measures, specifically the investment tax credit and depreciation allowances.

The subject of this hearing is the impact of the tax system on productivity. Because productivity is inextricably linked with capital investment, we believe that the most important aspects of the tax code impacting on our nation's productivity are the provisions creating incentives for capital investment.

The Committee for Effective Capital Recovery stands firmly behind the Accelerated Cost Recovery System and the improvements in the investment tax credit adopted by Congress in the Economic Recovery Tax Act of 1981. We believe that the curtailments made to these provisions in the Tax Equity and Fiscal Responsibility Act of 1982 should be reversed, specifically to restore the full benefit of the investment tax credit and the scheduled increases in the rate of recovery.

Recent findings indicate that the capital recovery tax provisions are among the most significant factors leading to our current economic recovery; therefore, the Committee believes that their maintenance and improvement should be a priority in devising any new or alternative tax scheme.

In recent months there has been a dramatic turnaround in productivity. The disastrous decline in productivity rates in the United States has finally been halted, largely as a result of new capital investment. Any adverse change in our tax policy pertaining to capital recovery at this time could throw business planning into disarray, frustrate our national goal of stimulating savings and investment, and seriously slowdown our economic recovery.

I. RELATIONSHIP OF PRODUCTIVITY, CAPITAL INVESTMENT AND THE TAX SYSTEM

Productivity is one of the most important measures of the health of our economy. Without growth in productivity, our living standards, both individual and as a nation, cannot rise. Therefore, factors affecting the rate of productivity are key to assuring a healthy economic future for the United States.

Productivity is generally measured as the amount of output per labor hour. According to the Treasury Department, "the single most important determinant of productivity per labor hour is the quantity of capital -- plant and equipment -- per worker."1/ Thus, to put it simply, when the amount of

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1/ Statement of Charles E. McClure, Jr., Deputy Assistant Secretary for Tax Analysis before the Oversight Subcommittee of the Senate Finance Committee, April 13, 1984.

capital increases at a more rapid rate than the amount of labor, productivity improves. There are, of course, a great many factors that influence the rate of productivity, among them being government regulations, changes in the make-up of the work force, availability and cost of energy sources, and expenditures for research and development, all of which play an important role. No factor, however, has had a more significant impact on the rate of productivity in the United States than the rate of capital investment.

In considering the influences on capital investment, one finds that few factors are more important than our rate of savings as a nation. According to Department of Commerce statistics, business savings in 1983 made up approximately 80 percent of the total national savings. Thus, business saving, which has been increasing steadily in relation to personal savings, is now the largest factor to be considered in examining total national savings.

In turn, the major factors impacting upon business savings are the capital recovery allowances of the Internal Revenue Code. For 1983, Department of Commerce figures indicate that these accounted for approximately 83 percent of all business savings.

Some history of the capital recovery tax provisions and the rate of productivity in the United States should help to amplify the importance of these tax provisions in influencing productivity.

II. RECENT HISTORY OF PRODUCTIVITY AND CHANGES IN OUR TAX SYSTEM

The rate of productivity growth for the United States in the 1970's through mid-1982 was dismal. Productivity actually decreased as a percentage change over the latter part of this time period. By 1979, the United States had fallen dramatically behind its trading partners, ranking last when compared with Japan, France, Germany, Canada and the United Kingdom. At the same time, the United States also ranked last when comparing United States investment as a percentage of gross domestic product with that of these same five industrialized nations.

In conjunction with this drop in the rate of productivity growth came high inflation and disappointingly small gains in real income.

A number of studies conducted to determine the cause of this downward trend in productivity reached the same conclusion: underinvestment in plant and equipment was the major source of the productivity problem.2/

By 1981, Congress recognized the urgent need for improved capital recovery measures. Too many corporations were paying large federal taxes on illusory profits -- profits that resulted solely from the impact of inflation. Such taxes led

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2/ See e.g., Productivity Policy: Key to the Nation's Economic Future, Committee for Economic Development (1983).

to reduced corporate cash flows and inadequate capital investments. This had a seriously deleterious impact on the economic health of our nation and its ability to compete with other nations.

Recognizing that a key to economic recovery was increased savings and investment in plant and equipment, Congress adopted the Accelerated Cost Recovery System (ACRS), i.e., the 10-5-3 year period allowances, as a part of the Economic Recovery Tax Act of 1981 (ERTA).

These changes in depreciation allowances provided that the cost of eligible property could be recovered in three, five, or ten years, depending upon the classification of property. The 1981 tax law also made beneficial changes in the recovery methods by increasing the rate of recovery. Further increases were scheduled to be phased-in in 1985 and 1986.

Finally, under ERTA, three-year recovery property was eligible for a six percent investment tax credit and five- and ten-year recovery property was eligible for a full ten percent investment tax credit.

Had these provisions been untampered with, we might well be further along the road to recovery than we are now. Unfortunately, in 1982 -- barely one year after ERTA was enacted -- the benefits provided by the ACRS provisions were curtailed.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress amended the capital recovery provisions by requiring a taxpayer to reduce the basis of his assets by 50 percent of the amount of investment tax credits (and other credits related to the property) or, alternatively, reduce the investment tax credit directly by two percentage points. Additionally, TEFRA limited the use of the investment tax credit to only 85 percent of the regular tax liability, rather than 90 percent; it also repealed the increased rates of recovery scheduled to go into effect in 1985 and 1986.

The fact that Congress initiated consideration of another major tax bill almost immediately after passage of the substantial and long-overdue changes in ERTA left business managers in their usual uncertainty vis-a-vis legislation. There is no doubt that some business investment plans were adversely affected because the modifications in TEFRA negatively altered the projected rate of return available from such investment.

However, despite the fact that the 1982 tax changes may well have delayed the arrival of the recovery, the basic changes enacted in ERTA were of sufficient positive impact that the economic recovery is now well underway.

III. IMPACT OF TAX CHANGES ON PRODUCTIVITY AND THE ECONOMY

The statistics on the rate of productivity have shown a remarkable improvement since mid-1982. In fact, the Department of Labor recently reported an increase in productivity for the eighteenth consecutive month. Table I on the following page shows this encouraging trend in productivity rates after a long decline.

TABLE I

Percent Change in Productivity Rate For The Business Sector

Year	Quarter	Output Per Hour
1984	1	4.1
1983	annual	2.7
1983	4	4.2
1983	3	1.2
1983	2	5.9
1983	1	1.9
1982	annual	-0.1
1982	4	3.2
1982	3	1.6
1982	2	-1.6
1982	1	-0.3
1981	annual	2.4
1981	4	-4.1
1981	3	4.7
1981	2	2.2
1981	1	5.9
1980	annual	-0.5
1980	4	1.0
1980	3	1.3
1980	2	-2.9
1980	1	1.5
1979	annual	-1.2
1979	4	-0.6
1979	3	-2.1
1979	2	-2.6
1979	1	-1.9
1978	annual	0.6
1978	4	0.4
1978	3	-0.7
1978	2	1.1
1978	1	0.2

Source: United States Department of Labor, Industry Analytical Ratios for the Business Sector, May 29, 1984.

When compared with the productivity levels of other industrialized nations this same improvement trend can be noted. Table II below shows the average annual percentage change in productivity for the U.S. compared with five of our major trading partners. While the United States ranked a dismal last in 1979, it is now second only to Canada. Improvement has been steady from the time the ERTA tax changes were proposed, except for the year TEFRA was enacted.

TABLE II

Average Annual Increases of Output Per Hour in Manufacturing

	1960-78	79	80	81	82	83
Japan	9.2	8.9	9.5	5.5	8.1	5.7
France	6.1	4.5	1.5	2.7	5.6	6.1
Germany	5.4	4.7	1.4	2.3	1.7	4.6
Canada	4.0	2.8	-2.2	2.6	-2.5	6.8
United Kingdom	3.6	1.1	-1.1	6.6	3.0	6.1
United States	2.9	.7	.2	3.5	1.2	6.2
U.S. Rank	6	6	4	3	5	2

Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, June 1984.

The tax changes in the capital recovery allowances have had a large and favorable impact on the level of investment. Because capital investment is key to growth in productivity, these tax changes are most likely largely responsible for the upswing in productivity rates.

Allen Sinai, Andrew Lin and Russell Robbins of Data Resources, Inc., analyzed the combined impact of ERTA and TEFRA, and compared it to what would have occurred in our economy had pre-ERTA legislation remained in effect. It was their conclusion that ACRS and the equipment investment tax credit avoided a more serious decline in business capital outlays than might have been expected during the long and severe economic downturn of 1981-82. And they estimated that additional investments in plant and equipment would increase by a range of $9 billion to $17 billion a year from 1983 to 1985.

Also, according to this study, ERTA has had a major beneficial impact on savings. In 1981 and 1982, the estimates of additional savings are $12.7 billion and $31.1 billion. And for 1983-85, the net effect of the tax law changes is estimated to be $58.3, $72.3, and $80 billion respectively.

Thus, Sinai, Lin, and Robbins concluded that the overall impact of the tax changes was very positive:

> [I]f there had been no ERTA and no TEFRA, the U.S. economy would have performed considerably worse in 1981 and 1982 than actually was the case. Simulation of a no ERTA, no TEFRA case . . . lowered growth in real GNP 0.3 and 1.3 percentage points in 1981 and 1982. For 1982, the resulting decline of real GNP was 3 percent, by far the deepest downturn since the early

> 1930's. Both personal and business saving also were down sharply. On balance, it would appear that the tax changes of the ERTA and TEFRA programs have been and will be positive for the U.S. economy . . . 3/

Recently, Charles McClure, Deputy Assistant Secretary for Tax Analysis at Treasury testified before this Subcommittee as to the beneficial impact of these tax provisions:

> The changes in taxation of business capital have lowered costs of capital to capital-intensive industries, reduced the tax bias favoring capital in the household sector over capital used by business, and increased incentives to invest in more durable capital. All of these changes should have beneficial effects on the growth of productivity in future years. In fact, real business fixed investment has grown 12.6 percent in the first four quarters of the current recovery, compared to an average of 5.7 percent in the first year of the five previous recoveries between 1954 and 1975. 4/

Unfortunately, despite all the concrete evidence of their benefit to our economy, there are still some who argue for further curtailment of ACRS and the investment tax credit.

IV. ARGUMENTS OF OPPONENTS

Tax Simplification

There is growing hue and cry in this country today for "tax simplification." The complexities of the present tax

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3/ Sinai, Lin, & Robbins, Taxes, Savings, and Investment: Some Empirical Evidence, 36 Nat'l Tax J. 321, 344 (1983).

4/ Statement of Charles E. McClure, Jr., Deputy Assistant Secretary for Tax Analysis, Department of Treasury, before the Oversight Subcommittee of Senate Finance Committee, April 13, 1984.

system have led some to the conclusion that all deductions, credits, exclusions, etc. should be eliminated from the tax code and that this will result in a more "fair" system of taxation.

While such a proposal has a certain superficial appeal, the difficult and sometimes insurmountable problems inherent in such an approach quickly become apparent as policymakers struggle to create a "simple" and "fair" system of taxation. Almost immediately, there are public announcements that certain preferences will be protected -- "Something must be done to protect homeowners with high interest mortgages," "Some provision is necessary to encourage charitable contributions" -- and the list will grow as the process continues.

It has been said that it would take a person who knows nothing about tax law to create a "simple" tax system. This is because there is a history and a rationale behind every provision in the current tax code. Those who have worked in the tax field for many years know too much about why a particular provision is needed to be able to just blithely throw it away in the name of simplification.

The capital and investment needs of industry and their impact on the U.S. economy have been closely studied over many years by both private and government economists. In light of the information gathered, Congress carefully crafted a response to those needs in the form of capital investment incentives in the tax code. The investment tax credit has been in effect, except for two short periods, since 1962, and accelerated depreciation allowances have been in effect in some form since 1954.

Both provisions have been fine-tuned over the years to meet this country's changing economic needs and they are well understood. In fact, they are a major simplification over the Asset Depreciation Range system in existence prior to ERTA, a system which included hundreds of categories of depreciable property. Having achieved this degree of simplification, what is needed now in the area of capital recovery tax provisions is a period of certainty and stability, not additional changes.

Tax Neutrality

Another argument that has been advanced against the capital recovery provisions is that they are not "neutral," i.e., that they result in an "inefficient" allocation of investments because they tend to favor some assets and some industries over others.

These critics, however, cannot even agree among themselves as to the direction in which investments may be skewed by the incentive provisions. Before this very committee, one expert complained that while ACRS resulted in increased investment in long-lived plant and equipment, the provision did not assist high technology companies that tend to replace plant and equipment frequently and prior to their economic obsolescence.5/ On the same day, another expert cited evidence that

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5/ Statement of Donald C. Alexander before the Oversight Subcomittee of the Senate Finance Committee, June 18, 1984.

accelerated depreciation and the investment tax credit had induced investment in short-lived, as opposed to long-lived, assets.[6]

As evidence of this alleged disparity of treatment, critics cite a 1982 study by the Joint Committee on Taxation of the average effective tax rates of all companies. But the fact that there are disparities in the effective income tax rate among different industries in any particular year should not come as a surprise to anyone. Of the various factors that could impact on a company's tax rate in a given year, ranging from the weather to labor-management relations, the impact of the capital recovery tax provisions is only one influence among many. It would be a serious mistake to conclude that the provisions should be eliminated based on these statistics.

Also, those who argue that high technology companies do not benefit as much as basic industry from the capital recovery provisions are ignoring two important facts. First, TEFRA instituted tax credits that remain in effect for research and development expenditures that go a long way toward equalizing the tax treatment of research intensive industries versus capital intensive industries. Second, much of the capital investment being made by industry is in computers and other high technology equipment which certainly redounds to the benefit of the research and development oriented industries in the form of direct profits.

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[6] Statement of Floyd K. Haskell before the Oversight Subcommittee of the Senate Finance Committee, June 18, 1984.

Other advocates of a "neutral" tax policy claim that the present system discriminates between rich and poor companies because industries which are currently in an economic slump, such as the steel industry, are unable to benefit at this time from the capital investment incentives.

Presently, any unused portion of the investment tax credit may be carried forward for a period of fifteen years. Increasing profitability due to the economic recovery should enable many more companies to use the credit, while the value of unused credits in future years remains higher when inflation is under control. Of course, reversing some of the negative changes made by TEFRA which curtailed the use of the capital recovery provisions would be extremely beneficial as well.

But looking at these provisions more broadly, there is ample evidence to indicate that the current system is far more efficient and effective than the tax law existing prior to ERTA.

One economist, Jane Gravelle of the Congressional Research Service, has attempted to quantify the "inefficiencies" in investment (i.e., the potential of the tax law to modify the flow of capital between more or less productive assets). She compared the inefficiencies existing under ERTA and TEFRA with those existing prior to ERTA. Her analysis considered the effect of tax policy on the allocation of capital both within the corporate sector and between the corporate and non-corporate sectors, thereby considering its total effect on economy-wide investment uses.

Her results are summarized in Table III below.

TABLE III

ANNUAL EFFICIENCY IN INVESTMENT ALLOCATION*

(Billions of Dollars)

Sector	Pre-ERTA	ERTA**	Effect of ERTA***	TEFRA	Effect of TEFRA***	Combined Effect of ERTA and TEFRA***
Intra-corporate Only	3.3	3.8	+.5	1.5	-2.3	-1.8
Economy-wide (Total)	17.4	11.9	-5.5	11.6	-.3	-5.8

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* All estimates measure impact of relevant law if it had been implemented in 1980.

** Based on depreciation schedule to have become effective in 1986.

*** Positive numbers reflect additional inefficiency, while negative numbers reflect a reduction in inefficiency.

Source: Gravelle, Capital Income Taxation and Efficiency in the Allocation of Investment, 36 Nat'l Tax J. 297 (1983). The study assumes Cobb-Douglas production functions, unitary price elasticities of demand for each type of labor, capital and final output, and exponential depreciation. Consumer durables, housing, and inventories are included as investments in non-corporate sector; education, gold, collectibles and other investments are excluded. See source for assumptions on investment financing, personal tax rates, and other items. State and local taxes are not considered.

Gravelle found that tax law prior to ERTA caused in 1980 an inefficiency or distortion in the allocation of corporate investment equal to $3.3 billion. This amount represents the difference between the allocation of the corporate sector's investment under such tax law and the "optimum" allocation of such investment.

She estimated that under ERTA, the corporate inefficiency would have been $3.8 billion per year, or an increase of $.5 billion over the pre-ERTA level.

When, however, Gravelle considered the efficiency of total or economy-wide allocation of investment, she found that by ERTA's lowering of effective corporate tax burdens relative to non-corporate taxes, efficiency was increased by a net gain of $5.5 billion per year.

Accordingly, this work contradicts claims of some critics that ERTA interfered with efficient flow of investment between alternative uses.

In the case of TEFRA, while the tax changes increased "efficiency" of corporate investment ($2.3 billion), the overall effect was not statistically significant ($.3 billion).

Thus, contrary to popular impression, in accordance with the analysis used by Ms. Gravelle, ERTA improved the allocation of investment in the economy while TEFRA had little or no effect on such allocation.

VI. CONCLUSION

Growth in productivity in the United States is essential to achieving higher standards of living and, ultimately, to improving the quality of our life. It is widely recognized that tax policy may adversely affect productivity by reducing incentives for capital investment and savings. In fact, some experts maintain that the low rate of investment in new plant and equipment was the major factor contributing to the decline in productivity growth during the past decade and a half.

In 1981, however, Congress made substantial revisions in the tax code which strengthened the incentives for savings and investment. As a result, the downward trend in productivity has been reversed and there are increasing signs that a strong and lasting economic recovery is underway.

It is important to recognize, however, that an adverse change in tax policy would again most likely result in a downswing in productivity and, concomitantly, a downturn in the recovery. What the country needs now to sustain long-term economic growth is a stable national policy that provides a steady stimulus for corporate savings and investment.

The Committee for Effective Capital Recovery believes that the combined effect of ACRS and the investment tax credit, as envisioned in ERTA, provide the necessary and appropriate stimulus for sustained productivity growth.

It is our opinion that any attempt to eliminate or to weaken these capital investment incentives in the tax code would create havoc in our economy and portend disastrous results for U.S. competitiveness overseas. Most industrialized countries reward savings and investment in some way through their tax systems. The elimination of the present incentives in our system would most certainly be a move in the wrong direction.

We urge Congress, in its consideration of any major or structural tax reform proposal, to insure that the system rewards savings and investment. It is our view that ACRS and the investment tax credit have an extremely successful track record in this regard and thus should be included in any such structural reform.

In addition, at the earliest practical time, consideration should be given to revising two of the changes to ACRS made by TEFRA, specifically eliminating the 50 percent basis reduction and restoring the rates of recovery originally scheduled to go into effect in 1985 and 1986.

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May 30, 1984

Rodrick A. DeArment
Chief Counsel, Committee on Finance
Room SD-219, Dirksen Senate Office Building
Washington, D. C. 20510

Re: Oversight of the Internal Revenue
Service Tax Impact on Small Business

Gentlemen:

The impact that Federal Income Taxes has on small business is terrific. As the small businessman grows from being the sole proprietor and the only employee of his business and as he hires employees, he discovers that his overhead goes up more than what he can increase the prices of the products and/or services that he is selling. He also discovers that due to the tremendous tax burden that he is unable to make his note payments, pay the interest on his notes, and pay the Federal Income Taxes that is due on the profits that he must make in order to make his note payments. After he has paid his Federal Income Taxes and his note payments, there is very little, if any, money left for the individual to pay for food, clothing and shelter, which is of vital importance to a person's livelihood.

He also discovers that he is faced with a long term recovery of costs in the form of depreciation. A small businessman should be permitted to charge off all of his expenses including the cost of the capital items that he purchases. This in turn would provide an income tax deduction that would enable the man to make his note payments and have money left over to live on without any tax burden for the short-run period until his notes were paid off.

The small businessman is the key to new jobs. The only way that new jobs are developed is for an individual to quit his job, start a small business of his own, and as the business grows, then the man must hire personnel to help him take care of the business. This is what really creates jobs. When you look at our Federal Income Tax system, you will find that due to all rules and regulations that an individual must follow, it absolutely does not pay for an individual to go into business for himself. In other words, Congress is responsible for the propagation of all these rules and regulations, which in turn has discouraged the formation of many, many new jobs. Unemployment could be reduced to zero if Congress would get off the backs of the small businessman and encourage him to get bigger and encourage him to hire more individuals. Your present rules and regulations do just the opposite of this.

Thank you for your time.

Yours truly,

Maxwell D. Green

Maxwell D. Green
Certified Public Accountant